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Public Finance in Adjustment Programs

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and
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Countries undergoing adjustment have increasingly found it difficult to sustain cuts in public sector deficits to match cuts in external financing, thus exacerbating inflation and financial disequilibrium. Moreover, fiscal contraction has often been short-term oriented. Fundamental fiscal reform involving a medium-term perspective has been rare. Given the central importance of fiscal issues in adjustment programs, however, greater focus on them is essential if such programs are to succeed.

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This paper, prepared in part as a background study for the Bank's Report on Adjustment Lending, reviews the experience with pubic finance issues under adjustment programs. This experience shows that fiscal changes are often triggered by budget and balance of payment crises. As a result, short-term considerations have dominated the policy measures introduced. Traditional stabilization policies usually emphasize measures aimed at reducing aggregate demand. On the fiscal side, this has implied cutbacks in public expenditures. There is, however, growing recognition of the need for more growth-oriented adjustment programs, which entail a more comprehensive and durable approach to fiscal reform and therefore require a medium-term perspective.

Countries committed to fundamental reform of fiscal and other key policy areas should be able to avail themselves of external financial support that lasts long enough for them to initiate and sustain the change process. They must strike a balance between stabilization and adjustment. On the expenditure side, this includes a much better understanding of and attention to compositional changes followed by reorientation of the expenditure program. On the revenue side, it entails comprehensive tax reform designed to reduce distortions, to increase buoyancy, and to ensure equity.

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PUBLIC FINANCES IN ADJUSTMENT PROGRAMS[1]

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1/ Background Paper for the Report on Adjustment Lending. John Brondolo and Reza Firuzabadi provided excellent research assistance. The authors are grateful for very useful comments to Bela Balassa, Francis Colaco, Pradeep Mitra, W. McCleary, Catherine Mann and Wayne Thirsk.

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I. Introduction

1. Public sector finances and related policies are a central part of economic management and influence overall macroeconomic performance as well as the distribution of resources between the public and private sectors. There is a growing recognition that the developing countries' efforts to restore and maintain macroeconomic stability with a reasonable growth of output must include wide-ranging fiscal reforms covering not only the size and financing patterns of government deficits, but also the structure of taxation and the level and composition of public expenditures. How government deficits are financed, taxes raised, and public resources allocated and utilized has important consequences for incentives, distribution and growth.

2. The broad objectives of this paper are to examine the role of fiscal reform in adjustment programs and to draw out the experience in this area, as well as the major lessons that emerge for the design of fiscal reform recommendations and conditionality in adjustment lending. While the scope of the paper is broad, the extent of the coverage of the issues and countries is highly selective and, moreover, the country references are more illustrative rather than exhaustive. Part II focuses on the macroeconomic implications of fiscal deficits, the extent to which they have been reduced in selected countries, the consistency of fiscal policy with other instruments, and the question of sustainability of fiscal policy and growth. Part III deals with expenditure policy issues, particularly those related to the level and composition of recurrent and public investment outlays. Part IV outlines the desirable elements of

change in tax systems and the experience with reform. The final section summarizes the key conclusions and outlines the set of fiscal considerations appropriate for inclusion in growth-oriented adjustment programs and lending.

II. Macroeconomic Aspects of Fiscal Adjustment

3. Over the past several years, many developing countries have faced macroeconomic imbalances, both external and internal, of varying degrees. There are many reasons why a country could face a problem of this nature. Among them are external factors such as terms of trade shocks, low demand in export markets, unanticipated reduction in, or cessation of, external capital flows, high interest rates on external loans, and inappropriate domestic economic policies and mismanagement. Often a combination of these factors is at work. Unless the underlying source of disequilibrium is temporary, in which case external capital, if available, could be used to cover the resource shortfall, adjustment so as to restore macroeconomic stability and revive growth is necessary. Depending on the source of macroeconomic disequilibria, the path of adjustment and the ease with which it can be carried out may vary.

4. Large public sector deficits, or, more generally, inappropriate expenditure and revenue policies, are an important source of macroeconomic disequilibrium in many developing countries. An economic crisis can be generated by heavy expenditures on subsidies, transfers to loss-producing public enterprises, or ambitious public investment programs. Attempts to restore economic stability often require adjustments in fiscal policy.

5. If adjustment is necessary, how much of it should take place in the public sector as opposed to the private sector? How much of the adjustment should be in the form of aggregate demand restraint and how much should come from efforts to increase supply? In the case of the former, i.e., reduction in aggregate demand, the need to reduce the budget deficit which is an indicator of the excess demand pressure exerted by the public sector on the economy is obvious. At one extreme, the approach may be to view fiscal policy as primarily an instrument for expenditure reduction, and to rely on other instruments such as the exchange rate and pricing to shift expenditures and resources towards tradeable goods--expenditure switching. But, the magnitude and the manner in which the budget deficit is reduced, and the consistency of other policies with fiscal policy significantly affect the ability of the economy to increase output and thereby diminish need to cut demand, and consequently affect as well the sustainability of fiscal changes. The availability of external finance to smooth the process of reform is, of course, a key factor.

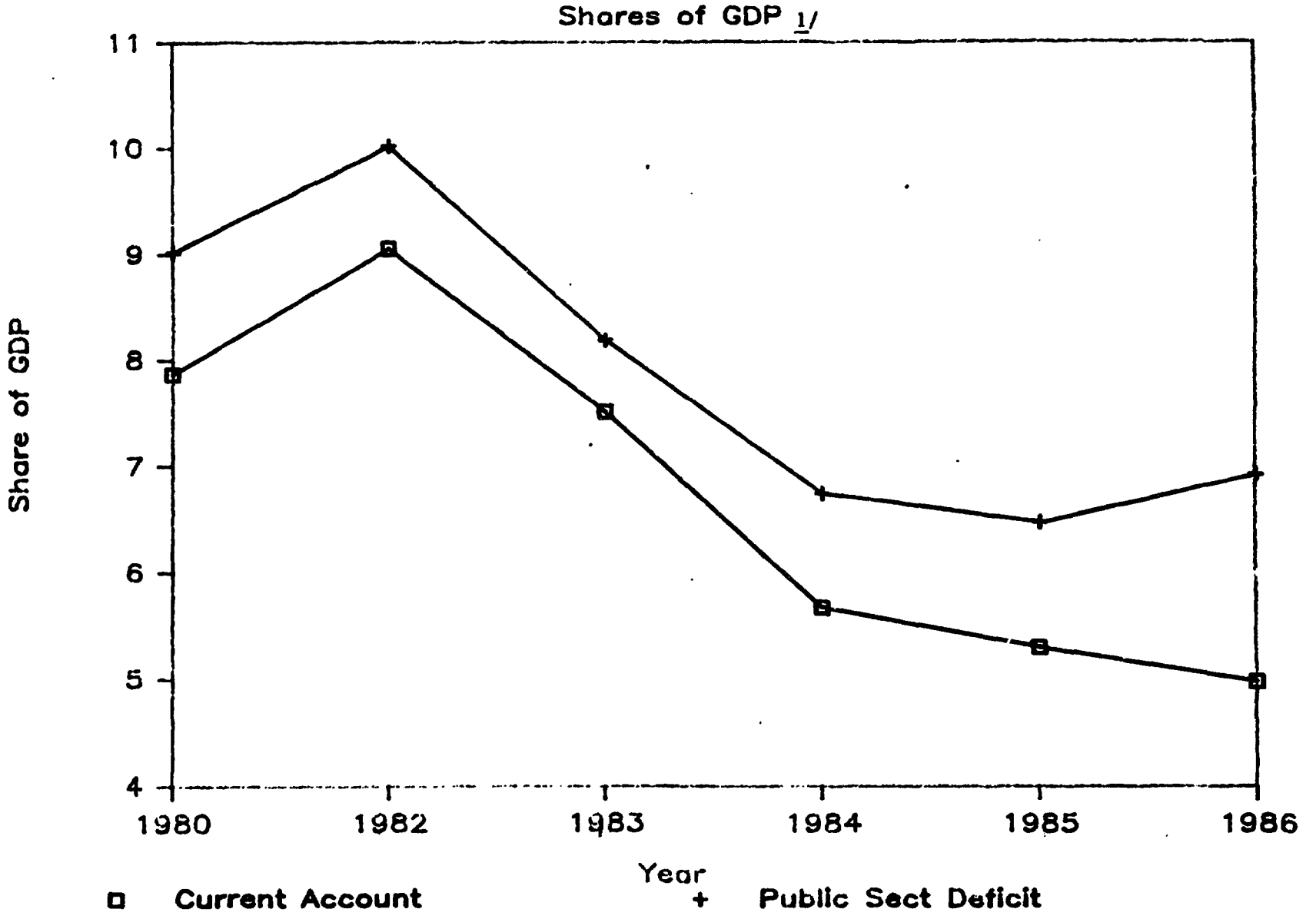
6. Has fiscal adjustment been enough in relation to the decline in external financing that has been experienced by many developing countries in recent years? If not, how have budget deficits been financed and what are the implications for the economy of alternate financing packages? Has fiscal policy "crowded-in" or "crowded-out" the private sector and thereby affected the sustainability of reform? An attempt is made to answer these questions, in a preliminary way, in the rest of this section along with a broad assessment of Bank-Fund conditionality on macro fiscal issues, and a discussion of consistency of fiscal policy with other instruments of adjustment.

Fiscal Deficit Adjustment: The Experience and Implications

7. Fiscal policy forms a key component of the policy package in most adjustment programs. This is inevitable since fiscal crises, in the form of large budget deficits, have been diagnosed as a primary feature of external disequilibria and macroeconomic instability in many developing countries. The massive flow of financial resources to the developing countries in the 1970s, largely recycled oil exporters' deposits, helped finance (or some may say caused) these deficits. Foreign savings were used to cover shortfalls in public sector savings. But since 1982 (see Figure 1), these flows dried up as the enormity of the debt build-up was revealed, exposing the underlying unsustainability of fiscal policy in a large number of developing countries. Moreover, external conditions deteriorated sharply; real interest rates rose dramatically, oil and commodity prices fell and industrial country growth decelerated reducing export markets. These factors added to the deterioration in economic performance and to fiscal problems. Heavy adjustments were required in the budget deficit and government expenditures, especially excluding interest payments which now rose sharply, had to be cut sharply.

8. With the onset of the debt crises, the burden of debt service on the government increased in many countries. This happened because of (1) higher international interest rates, (2) devaluation which raised the foreign interest bill in domestic currency, (3) takeover of private debt by the public sector and (4) increased domestic borrowing at high

Current Account and Public Sector Deficit



1/ Unweighted average for 33 randomly selected countries.

domestic interest rates (Brazil, Turkey, Pakistan and Malaysia). Table 1 shows the declining shares of private non-guaranteed debt in medium and long term debt which came about due to reduced foreign credit to the private sector and the takeover of some of the private debt by the public sector so as to avoid problems of credit-worthiness which would restrict other sources of credit. This was particularly true in Latin America and in some countries in East Asia. Note that in the case of Latin America there was a substantial absolute decline in private non-guaranteed debt. Since 1982, substantial reductions in the size of the fiscal deficit have taken place in a number of countries (Figure 1). However, the extent of fiscal deficit adjustment has in many cases been smaller than the cuts in availability of external funds.

9. Trade-offs in Financing the Fiscal Deficit. The implication of a smaller reduction in the budget deficit than in the current account can be best understood by looking at the sources of financing the fiscal deficits. A fiscal deficit can be financed in three ways:[1] (a) external borrowing or grants; (b) domestic borrowing from the banking system; and (c) domestic borrowing from non-bank sources. A large fiscal deficit creates problems in terms of one or more macroeconomic targets depending on how it is financed. Large external borrowing creates a debt problem; inflationary financing leads to high inflation; and heavy domestic borrowing either leads to insufficient credit availability to the private sector if credit is allocated by the government and financial

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1/ The build-up of arrears has emerged in recent times as a significant fiscal issue. These can be treated as forced borrowing by the government and can have very damaging impact on fiscal credibility of the system.

Table 1

Total Long Term Debt by Region and the Share a/ of Private Non-Guaranteed Debt
(US$ billion)

	1980	1982	1986
All Countries	433.6	556.9	870.7
	(17.2)	(18.4)	(10.4)
Africa, South of Sahara	44.1	56.3	88.2
	(6.4)	(6.9)	(4.6)
East Asia and Pacific	64.2	88.0	149.1
	(18.1)	(19.4)	(13.1)
Latin America and Caribbean	172.4	237.7	351.8
	(25.0)	(26.2)	(14.4)
North Africa and Middle East	46.8	51.4	71.3
	(1.3)	(1.6)	(1.8)
South Asia	33.4	39.4	61.6
	(1.1)	(3.3)	(4.4)
High Debt Countries	204.1	277.6	414.0
	(28.1)	(28.3)	(14.4)
Low Income Africa	27.0	31.8	46.3
	(3.8)	(2.3)	(1.1)

a/ Figures in brackets are share of private non-guaranteed in total. The balance is public and publically guaranteed.

Source: The World Bank, World Debt Tables, 1987-88.

institutions controlled by it or it leads to high real interest rates and less private sector credit, which reduce private investment and future output growth. A large budget deficit can therefore have adverse implications for three key macroeconomic targets: debt, inflation and the growth rate of the economy.[2]

10. The real counterpart of these financial flows is the relationship between the budget deficit, foreign savings and net private savings. The budget deficit is equal to foreign savings (current account balance) and the net savings of the private sector. If external flows are not forthcoming, the government's budget deficit must imply a corresponding net private savings surplus. This can be elicited by high inflation, which acts as a tax on holders of money, or through high real interest rates which could lower private investment and sometimes raise savings.

11. Large and unsustainable fiscal deficits have quite clearly been a central element in the economic crises faced by many developing countries. Government expenditures rose sharply for varied reasons in the 1970's. In some cases it was the misperception that a temporary commodity boom was permanent, in others it was the easy availability of cheap external finance. Once expenditures rose, they were more difficult

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2/ For a fuller exposition see W. Buiter, (1985): "A Guide to Public Sector Debt and Deficits", Economic Policy 1 (November):13-19 and "Turkey: External Debt, Fiscal Policy and Growth (1988)", World Bank, Green Cover Report. See also World Development Report, 1988, for a detailed treatment of many of these issues.

to cut back. A marked feature of fiscal crises was a rapid prior expansion of credit to the government or the public enterprises (See Table 2). Five countries shown in the Table--Argentina, Malawi, Nigeria, Mexico and the Philippines--had a large build up of credit to the government or the public enterprise sector prior to a financial crises. Once the crises occurred, the credit squeeze affected both the public and the private sector. In the case of Malawi and the Philippines, where more recent data is available, the private sector was affected much more than the public sector by the credit squeeze. Countries which restrained the growth of credit to the public sector, such as for example Pakistan, Korea and Indonesia, appear to have avoided those problems. Both Korea and Indonesia had temporary problems in the early 1980s again because of excessive credit expansion to the government but adjusted very quickly by among other things cutting growth of credit to the public sector drastically.

12. Internal financing of the fiscal deficit (as opposed to borrowing from abroad) has increased particularly since 1985. The gap between the public sector deficit and the current account has widened and net private savings have risen (as seen in Figure 1). If external financing has declined, the pressure from excessive budget deficits falls on inflation or on higher interest rates unless the private sector can be persuaded to hold government debt at low levels of interest. High inflation and high real interest rates are indicators of the need for further fiscal contraction in the economy.[3] Bringing inflation down to

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3/ There is a growing literature on the various concepts of the fiscal deficit and how they reflect on the fiscal stance of the government. These are summarized in Box 1.

Table 2

Pattern of Growth of Real Domestic Credit
(Percent per annum)

	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86
Argentina (1982)*						
G	337.2	23.1	320.4	-135.9		
PE	98.2	895.4	-185.0	-174.9		
PV	58.4	27.1	-27.5	-100.8		
Malawi (1981)*						
G	74.6	16.6	12.0	-5.9	9.2	23.0
PE	-7.4	-3.7	-13.0	14.4	20.0	-8.2
PV	-12.2	4.9	4.8	-23.9	-20.8	0.1
Nigeria (1983)*						
G	63.4	53.9	43.9	6.9	-7.0	
PE	16.2	-13.0	98.5	-34.6	-9.2	
PV	17.6	8.4	-1.1	-1.5	-1.2	
Mexico (1982)*						
G	22.8	113.1	-37.7	-30.1	35.8	
PE	33.5	92.1	18.5	9.5	-24.9	
PV	18.6	-36.5	-48.5	23.4	-1.3	
Philippines (1983)*						
G	51.3	74.9	14.7	-44.2	-27.5	69.2
PE	5.3	25.3	34.3	-19.4	10.0	-48.2
PV	10.7	5.1	15.3	-50.0	-35.2	-23.8
Pakistan						
G,PE	-4.0	19.2	3.2	2.5	-1.4	9.5
PV	10.0	10.8	14.0	7.6	22.2	12.9
Korea (1981)*						
G	69.5	18.1	-1.6	0.6	4.5	8.9
PE	21.5	20.5	17.4	-3.9	-4.0	-2.4
PV	10.8	18.6	13.7	10.3	15.0	12.7
Indonesia (1981)*						
G	52.3	5.6	-18.1	51.4	6.6	
PE	-21.4	11.0	-14.0	-7.4	3.2	
PV	21.4	35.6	15.3	23.5	16.3	

Source: International Financial Statistics, IMF.
G-Government; PE-Public Enterprises, PV-Private

* Indicates the year when a major economic crisis occurred in the country.

moderate levels is necessary to reduce uncertainty and provide the stable environment for adjustment. Contrary to trends in the industrial countries, inflation increased in the developing countries in the early 1980s and has remained high (See Table 3).

Table 3

AVERAGE ANNUAL INFLATION
(CPI)

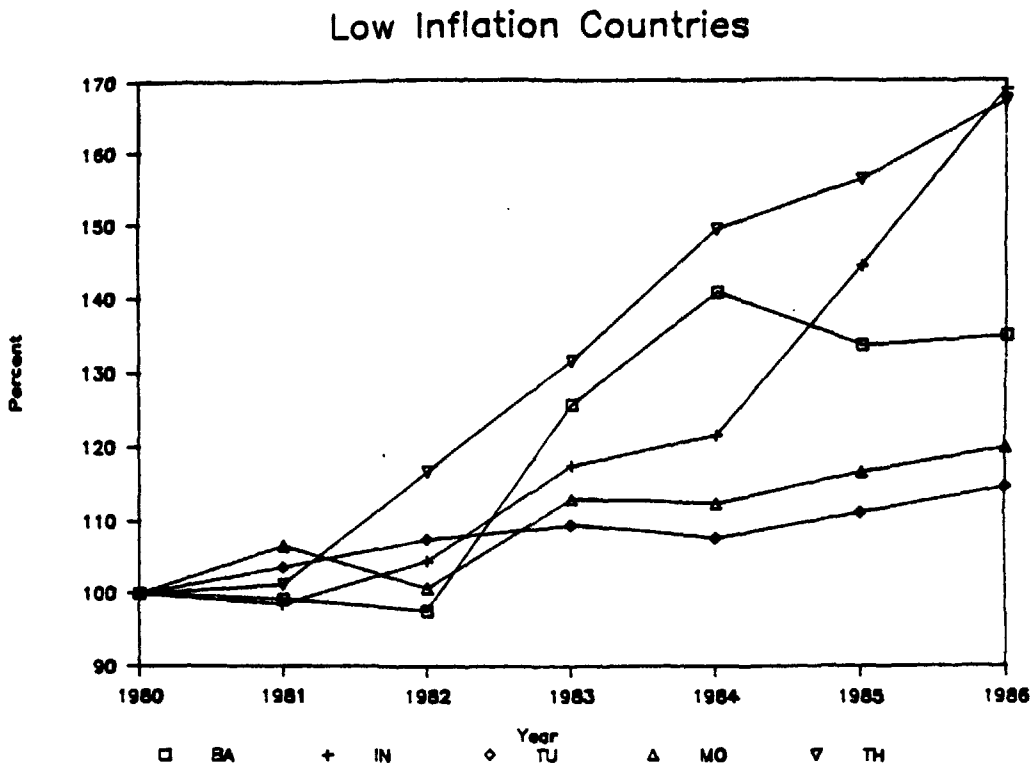
Category	1973-80	1980-84	1985	1986
SAL Intensive Countries	15.8	20.9	16.4	15.3
World	12.6	13.3	13.5	8.6
Industrial Countries	9.9	6.9	4.3	2.4
Developing Countries	22.6	35.4	47.0	29.8

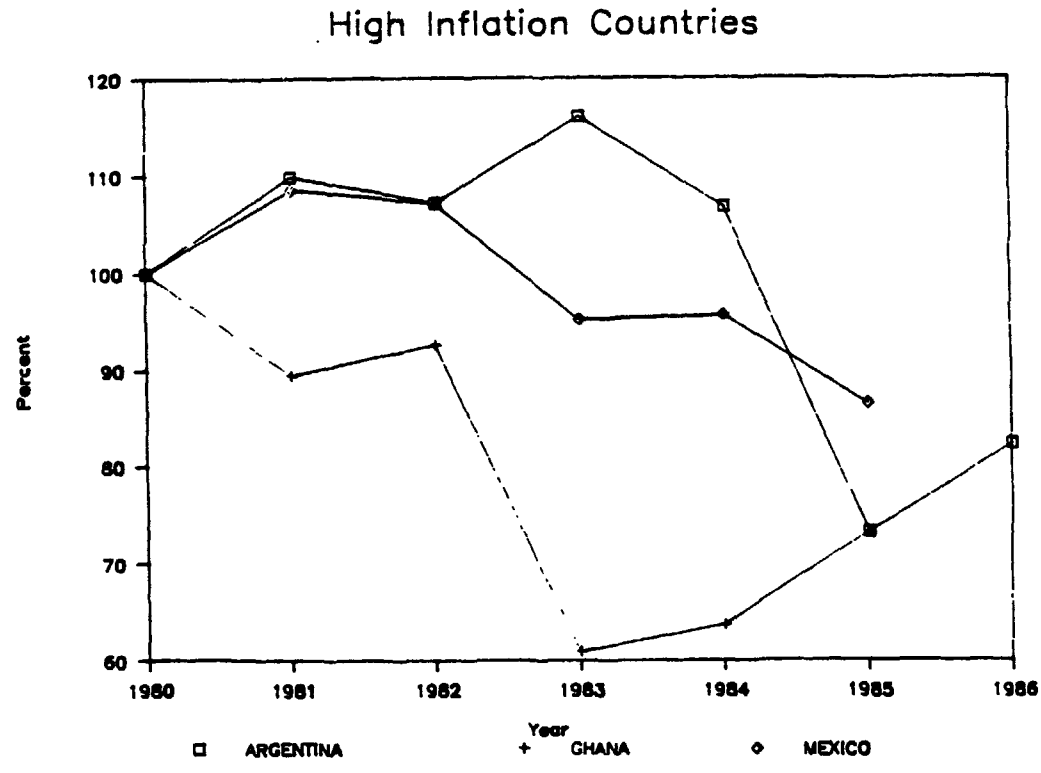
* The SAL Intensive Countries include: Chile, Colombia, Côte d'Ivoire, Jamaica, Korea, Malawi, Mexico, Morocco, Pakistan, Philippines, Thailand, Turkey, Zambia. These countries received three or more adjustment loans prior to 1987.

Source: International Financial Statistics and World Bank Reviewed File.

13. There are limits to both sources of internal financing. The inflation tax increases the cost of holding money so that the monetary base declines. Figure 2 shows the marked declining trend in the ratio of money to GDP in a sample of high inflation countries in contrast to its stable and in some cases increasing trend in low inflation countries. Beyond a certain level, with explosive inflation the revenue from the inflation tax begins to fall. This happened in Argentina in 1984 when despite accelerating inflation, the revenue from the inflation tax fell. A currency reform was inevitable. High inflation also increases the size of the deficit although it might assist in its financing. Under high inflation, tax revenues fall because of

Figure 2: Index of Ratio of Money to GDP





collection lags,[4] tax evasion and lack of indexation of nominal interest expenses which generally fully reflect inflation. In some countries the government increased its seignorage revenues without monetary expansion by increasing the reserve requirements on deposits in the domestic banking system. An increase in reserve requirements was resorted to, for example, in Uruguay, Mexico and Ghana.[5]

14. Some countries have attempted to impose price controls in a bid to control inflation, often in the mistaken belief that inflationary expectations contributed to high inflation. In Brazil under the Cruzado Plan, price controls were put in place as a vigorous expenditure program was being undertaken. Real wages were increased by 8% and with price controls public enterprise deficits increased. A consumer boom eroded the trade surplus and the program collapsed with much higher inflation than before the plan was put in place.[6]

4/ See Tanzi, V (1977): "Inflation, Lags in Collection and the Real Value of Tax Revenues", IMF Staff Papers, 24: 154-67.

5/ For details see Appendix A, Table A.1.

6/ See Cardoso, E. and R. Dornbusch (1987): "Brazil's Tropical Plan", AER Papers and Proceedings, 77 (May): 288-92.

15. Countries which tried to finance large budget deficits through the sale of public bonds to the private sector faced problems of high real interest rates. If the real interest rate exceeds the real growth of public revenue, this source of financing is unsustainable as the growth of domestic debt becomes explosive. The problem of high real interest rates and explosive domestic debt is particularly acute, for example, in Brazil.[7] In order to avoid this problem, some countries such as Mexico used mandatory sales of government bonds at low and often very negative interest rates to raise finance. Financial repression was used to ensure that funds were available to the public sector at highly negative interest rates, eroding confidence in the domestic financial system and leading in many cases to capital flight.

16. These problems are interconnected and ultimately arose in those countries which did not sufficiently reduce their budget deficits. Therefore, adjustment policies were difficult to pursue in this unstable macroeconomic environment. In many cases, confidence in the government and the financial system fell and investment ground to a halt. But this raises the issue of what is a sustainable level of the budget deficit in relation to a country's debt and growth strategy? Too large and too rapid a cut in the fiscal deficit can also be costly. If reducing the budget deficit in order to contain debt and inflation comes at a heavy cost to growth, the sustainability of reform is obviously in question.[8] The composition of public expenditure cuts and the effect of overall

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7/ See Appendix A, Table A.2.

8/ See Corbo, V., M. Goldstein and M. Khan eds (1987) "Growth-Oriented Adjustment Programs", Washington, D.C.; IMF/World Bank.

fiscal policy on private savings and investment matter a great deal. Before discussing these issues, however, it would be useful to review the experience of the selected SAL sample countries and discuss the question of consistency between fiscal policy and other adjustment instruments.

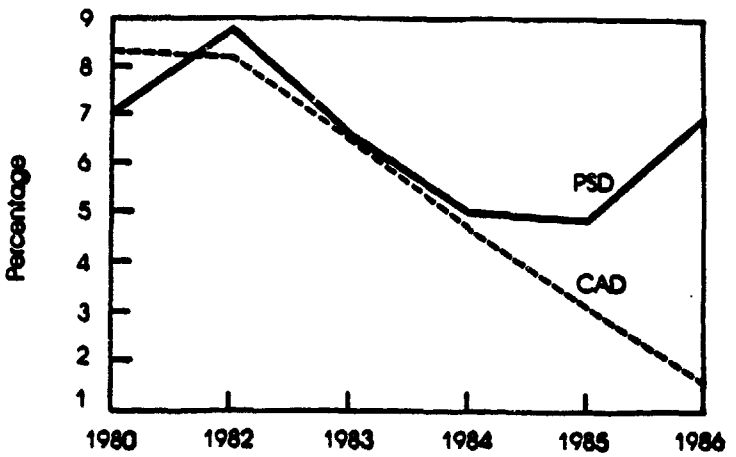
Fiscal Deficit Adjustment in SAL Countries

17. The reduction in the budget deficit follows the decline in the current account balance closely in the sample SAL countries (Figure 3) upto 1984. But after 1984, there is again substantial divergence between the public deficit and the current account balance implying increased pressure on the private sector to generate a net savings surplus. If anything, SAL intensive countries appear to have greater difficulty in later years in controlling the fiscal deficit, because of greater terms of trade shocks and rising interest payments. Domestic financing of the budget deficit rose sharply in a number of countries (Table 4).[9] As a result some countries such as Zambia and Mexico faced problems of high inflation which in turn led to higher deficits; whereas others such as Turkey,[10] Philippines and Thailand experienced high real interest rates.

9/ In Colombia (1986) and Chile (1985, 1986) the government reduced its domestic obligations.

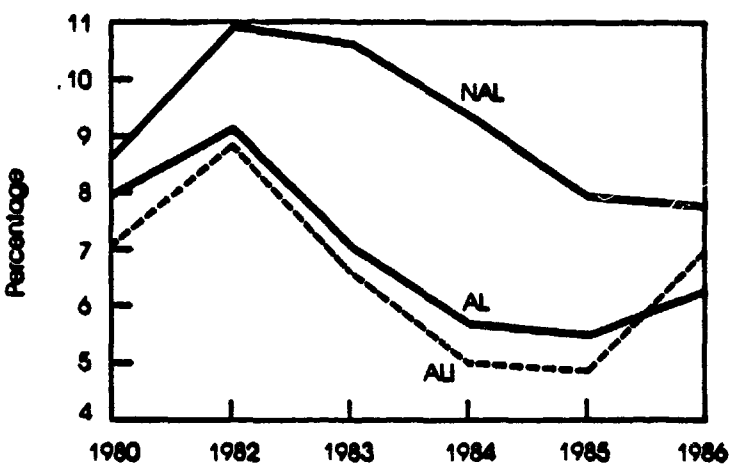
10/ Turkey's inflation rate was also high but not explosive averaging 30-40 percent per annum between 1980 and 1986.

Figure 3: **CURRENT ACCOUNT AND PUBLIC SECTOR DEFICITS**



Notes: CAD = Current Account Deficit as percentage of GDP
PSD = Public Sector Deficit as percentage of GDP
Unweighted average for 13 AL countries (Chile, Colombia, Cote d' Ivoire, Jamaica, Korea, Malawi, Mexico, Morocco, Pakistan, Philippines, Thailand, Turkey, and Zambia.)

PUBLIC SECTOR DEFICIT AS SHARE OF GDP



Notes: ALI = Unweighted average for 13 adjustment lending intensive countries
AL = Unweighted average for 25 adjustment lending countries
NAL = Unweighted average for 16 non adjustment lending countries

Source: World Bank data.

Table 4

Budget Deficit and its Financing in Selected SAL Countries
(% of GDP) a/

	1982	1983	1984	1985	1986
Chile	3.5	3.0	4.4	2.6	2.3
	(37.1)	(133.3)	(38.6)	(-57.7)	(-56.5)
Colombia	4.4	4.5	4.4	2.6	1.4
	(56.9)	(66.2)	(72.1)	(11.6)	(-540.0) b/
Cote d'Ivoire	15.2	9.5	3.8	1.9	1.7
	(25.6)	(86.8)	(-73.2)	(-58.6)	(14.3)
Jamaica	12.3	13.7	4.0	3.2	1.7
	(1.3)	(27.6)	(40.4)	(51.4)	(151.8)
Korea	3.3	1.0	1.1	1.5	1.6
	(60.6)	(30.0)	(54.5)	(60.0)	(7.50)
Malawi*	12.5	10.3	8.9	8.1	12.0
	(34.1)	(16.0)	(50.8)	(66.7)	(48.9)
Mexico	17.7	8.4	7.2	9.0	15.6
	(124.4) c/	(149.4) c/	(147.9) c/	(127.0) c/	(93.1)
Morocco*	9.5	10.9	6.9	8.4	5.5
	(30.6)	(107.0) c/	(31.8)	(126.8) c/	(622.2) c/
Pakistan	5.3	7.0	6.0	8.0	7.7
	(69.8)	(77.5)	(80.0)	(85.7)	(79.2)
Philippines	4.2	2.0	1.9	1.9	4.5
Thailand	5.7	4.3	4.2	5.0	5.2
	(56.8)	(66.7)	(55.8)	(70.5)	(77.8)
Turkey*	1.8	2.6	5.4	2.9	3.2
	(N.A)	(73.9)	(63.9)	(132.6) b/	(123.5) b/
Zambia	18.7	8.1	6.6	8.0	28.2
	(78.6)	(66.7)	(63.6)	(87.5)	(40.1)

a/ Figures in brackets are percentage of domestic financing to total deficit.
b/ A negative number implies that domestic debt of the government was being reduced.
c/ A number larger than 100.0 implies foreign debt of the government was being reduced.

* Central government only.

Source: IMF and World Bank Data.

18. Table 5 provides a more disaggregated picture of the relationship between the public deficit and the current account of the balance of payments. In a majority of the cases an improvement in the fiscal deficit is associated with an improved external account. The exceptions are Thailand where the external position showed improvement while the budget deficit increased. On the opposite end is Jamaica where the budget deficit fell while the external position worsened. In both cases unexpected terms of trade changes explain the divergent trends in the public sector and external deficits. In Thailand, improvements in the terms of trade, brought about by increases in prices for Thailand's exports and a fall in oil prices, reduced the external deficit, whereas in Jamaica the fall in the price of bauxite/alumina had a much larger adverse impact on the external account than on the fiscal side.

19. Fiscal adjustments in the sample SAL countries were on the whole not very different from a larger sample of developing countries. It should be noted of course that the larger sample includes many cases where the Fund has had stand-by, SAF or EFF agreements. Between 1982 and 1986 changes in the budget deficit were effected largely through changes in real expenditure. There was very little increase in revenues (Figure 4). Real expenditures fell sharply between 1982 and 1984 (Table 6) but then rose substantially in some countries such as Mexico, Malawi, Philippines and Zambia where economic growth was disrupted for a variety of reasons, and the adjustment programs suffered severe setbacks.

Table 5

Correlation of External and Fiscal Positions in Selected SAL Countries 1980-86 a/

		External	
		Worsening	Improvement
FISCAL	Worsening	Malawi Mexico, Pakistan Turkey, Zambia Cote d'Ivoire	Thailand Pakistan Philippines
	Improvement	Jamaica	Chile, Colombia Korea, Malawi Mexico, Morrocco Pakistan Philippines, Turkey Zambia, Cote d'Ivoire

a/ Countries listed more than once indicate there was no uniform pattern.

Note: External refers to the current account balances, fiscal to the public sector deficit.

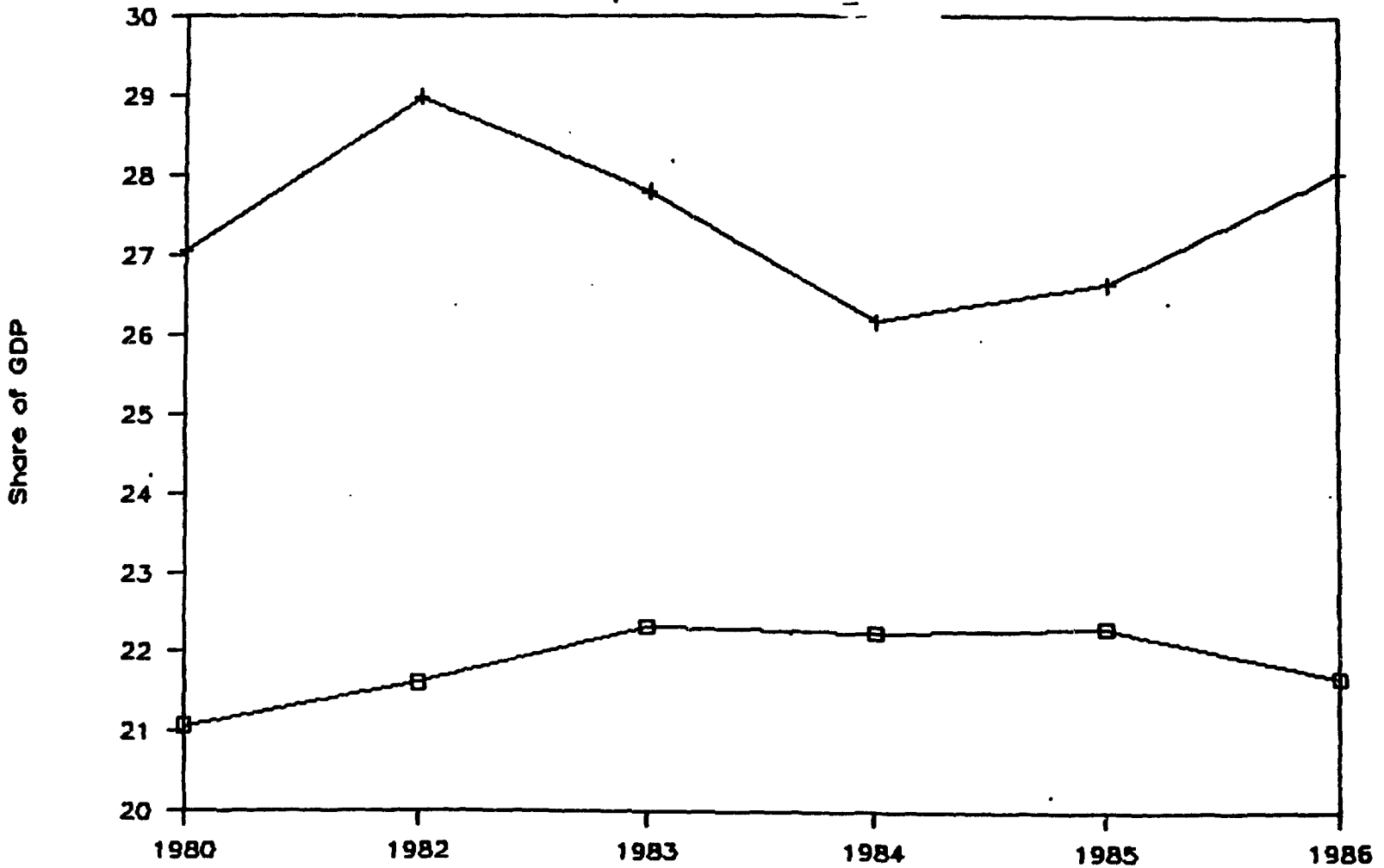
20. Malawi's problems arose from the combined effect of terms of trade deterioration and the difficulties it has faced in keeping its lines of communication open. As a result of terms of trade losses, imports had to be curtailed and revenue from import duties fell. Company taxes also registered a drop as economic activity was curtailed. At the same time expenditures rose sharply reflecting increased military expenditures and a general lack of budgetary monitoring and discipline.

21. The sharp drop in the price of copper and the government's inability to control expenditures are the primary causes of Zambia's financial crisis. As the exchange rate was devalued, the rising domestic currency costs of debt repayment led to further fiscal deterioration. Subsequently, the government suspended the reform

Figure 4

Total Revenue and Expenditure

Sample SAL Countries 1/



1/ Unweighted average for: Chile, Colombia, Cote d'Ivoire, Jamaica, Korea, Malawi, Mexico, Morocco, Pakistan, Philippines, Thailand, Turkey, Zambia

Table 6

Public Sector Expenditure and Its Composition
(Percent of GDP)

Country	Current	Capital	Total	Country	Current	Capital	Total
Chile				Mexico			
1982	31.9	4.7	36.6	1982	37.6	9.9	47.5
1984	30.7	6.4	37.1	1984	32.7	7.5	40.2
1986	27.1	7.7	34.8	1986	40.6	5.8	46.4
Colombia a/				Morocco a/			
1982	8.9	3.8	12.7	1982	23.4	11.9	35.3
1984	9.7	2.7	12.4	1984	23.9	8.7	35.3
1986	9.5	2.3	11.8	1986	22.8	4.2	27.0
Cote d'Ivoire				Pakistan			
1982	26.5	15.2	41.7	1982	14.4	7.7	22.1
1984	27.3	8.0	35.3	1984	17.8	6.1	23.9
1986	26.7	6.3	33.0	1986	18.0	6.9	24.9
Ghana				Philippines a/			
1982	-	-	-	1982	9.1	3.0	12.1
1984	8.6	2.5	11.1	1984	8.0	1.9	9.9
1986	11.9	6.1	18.0	1986	10.6	2.1	12.7
Jamaica				Thailand a/			
1982	29.8	12.5	42.3	1982	15.0	4.5	19.5
1984	28.2	5.8	34.0	1984	15.4	3.7	19.1
1986	26.4	7.5	33.9	1986	16.4	3.7	20.1
Korea				Turkey			
1982	16.4	6.5	22.9	1982	10.9	12.2	23.1
1984	15.4	6.1	21.5	1984	8.9	10.0	18.9
1986	16.2	6.1	22.3	1986	8.8	14.1	22.9
Malawi				Zambia			
1982	21.0	11.2	33.2	1982	32.3	2.8	35.1
1984	21.6	8.2	29.8	1984	26.4	2.5	28.9
1986	24.6	7.8	32.4	1986	41.9	6.3	48.2

a/ Central Government Only.

Source: World Bank Data.

program. Terms of trade losses due to a weakening oil market and inability to rein in expenditures were also a major factor in the difficulties Mexico faced in its adjustment program. In Philippines, the deterioration in the fiscal accounts from 1985-86 onwards reflects large losses on poorly selected private sector projects financed with loans and guarantees from public financial institutions whose losses were then covered by the government.

22. A common feature in the difficulties faced by all these countries was a large budget deficit in relation to the availability of external inflows and domestic savings as well as the inability to plan for and deal with higher interest payments and the changes in their terms of trade. High budget deficits are also prevalent in some countries such as Pakistan but have not yet led to macroeconomic instability. This is due partly to Pakistan's ability to draw down accumulated foreign reserves and at the risk of accumulating a large domestic debt whose impact will be felt in the future.

Consistency of Fiscal Policy with other Measures

23. Consistency between various components of the adjustment program is a major concern in the design of adjustment programs. Almost every component of an adjustment program has fiscal implications. In particular, exchange rate and trade policies, financial liberalization and price liberalization in selected sectors have large effects on the budget. Unless these effects are anticipated and appropriately

incorporated into fiscal programming, their impact through the budget can sometimes be destabilizing and disruptive, possibly leading to a collapse of the program and policy reversals.

24. The need to get consistency between the Fund and the Bank on some of these issues is another complicating factor. In several of the early loans, difficulties in coordination of policies arose due to the desire of both institutions not to impinge on each other's jurisdiction. Lately, the Bank has found it necessary to take a more active role in exchange rate and fiscal policy in order to achieve better consistency in its adjustment programs. At the same time the Fund is planning greater emphasis on the medium-term effects of its programs.

25. Fiscal and Exchange Rate Policies. Consistency between fiscal and exchange rate policies is a major issue in the design of adjustment programs. In general, the need for coordination between the two is obvious. Devaluation is unlikely to be effective unless accompanied by appropriate reductions in demand management policies, including a tight budget. This would reduce aggregate demand and imports, thereby lowering the pressure on the current account. Without appropriate fiscal restraint, the real effective devaluation is quickly eroded, inflation increases with little resource allocation effects.

26. Coordination between exchange rate and fiscal policy can become complex since exchange rate changes affect the size of the budget deficit. With a nominal devaluation, the base for customs duties, which form a substantial share of revenue in many developing countries, is now evaluated at a more favorable exchange rate. The revenue from this

source would increase unless the government reduces tariff rates by the extent of the devaluation. Export incomes rise and government revenues will increase either from higher export taxes or through increased profits or reduced losses of state-owned enterprises. Public sector corporations with access to the overvalued foreign exchange would now lose heavily, and may need large supporting transfers from the budget. Typical examples would be power authorities, or the agencies which runs the food subsidy system.

27. On the loss side, an increasingly important component would be the domestic currency counterpart of foreign debt service which would now rise in direct proportion to the devaluation. In a large number of developing countries, devaluation has resulted in a marked rise in the local currency equivalent of foreign interest payments (see Table 7, Section III). Moreover, an important consequence of devaluation (real), often ignored, is its impact on revaluation of existing external debt. In general, if including debt service the government is a net importer of tradeable goods and services it will lose net revenues through a devaluation. The assessment of the impact of devaluation on the budget can be quite complicated if there are multiple exchange rates. The government then receives and allocates foreign exchange at various rates to different entities in the economy.

28. If the impact of devaluation is likely to be adverse on the budget, it may be counterproductive to recommend a free float of the currency (such as an exchange auction). Movements in the exchange rate and the budget deficit may reinforce each other in a destabilizing manner as happened in the case of Zambia, Sierra Leone and Bolivia where

black market premia accrued to the government before the devaluation and, correspondingly, the fiscal situation deteriorated following the devaluation.[11] In this case, a series of managed exchange rate changes programmed with an overall reduction in the budget deficit may be a much safer alternative; with some priority in sequencing given to deficit reduction.

29. Consistency with Other Policies. Consistency issues also arise with respect to trade policy. The first stage of the Bank's trade reform recommendations usually involve a shift from QR's to tariffs which improve the fiscal position of the government. Subsequent reductions in the tariff rate involve the need for compensating fiscal measures. In general the Bank's tariff reform recommendations have focussed on this problem. The danger arises when governments do not implement compensatory fiscal measures, which then can lead to policy reversals as happened in the case of Morocco.

30. Sectoral price liberalization usually benefits the government budget. In many cases the benefit comes from a decline in state enterprise losses. However, if a sector is a net taxpayer, price decontrols can have adverse fiscal impact. This is often the case for the agricultural sector where prices paid to farmers are kept low through export taxes and below market procurement prices. Price increases to the farm sector unless compensated by removal of input subsidies affect the budget. A comprehensive price liberalization

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11/ See Brian Pinto (1987): "Black Market Premia, Exchange Rate Unification and Inflation in Sub-Saharan Africa", Mimeo, World Bank, Washington, DC.

involving several sectors would have less problems as the government's losses in one sector would be made up by gains in others. Individual sector adjustment loans would, however, need to direct attention on this issue.

31. An issue of great concern to many governments is the short-run inflationary consequences of price liberalization--the release of repressed inflation.[12] The predominant approach to assessment of inflation in adjustment programs is a straightforward macroeconomic one, that runs through the relationship between fiscal deficits, the financial program and targetted inflation rates. However, the immediate burst in prices following decontrol and liberalization can lead to policy reversals if the impact of deficit reductions on inflation takes effect over a longer period. This is often a key reason for the reluctance of many countries to adopt Bank/Fund programs. Much greater care is needed in coordination of public enterprise price policy and fiscal policy.

Fiscal Deficits, Public Sector Size and Growth

32. Longer term structural adjustment questions deal with issues about the role and the relative size of the public sector. Long-run trends indicate that the size of the public sector increases with

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12/ See for an empirical illustration: Feltenstein, A and Ziba Farhadian (1987) "Fiscal Policy, Monetary Targets and the Price Level in a Centrally Controlled Economy: An Application to the Case of China", Journal of Money, Credit and Banking 19,2 (May): 137-56.

economic development.[13] Contrary to a widespread belief, the government dominates to a far greater extent resource mobilization and its allocation in the more developed countries. On the expenditure side, richer countries appear to spend a lot more on health, social security and welfare. On the revenue side the more developed an economy the more revenue (as a share of GNP) it collects from income and wealth taxes, social security contributions and domestic indirect taxes. The only category which declines with development is taxation on international trade. Governments also play a supporting or restrictive role through a myriad of rules, procedures and regulations. No direct evidence on these is available. The notion that the public sector has become too large in many developing countries cannot therefore be based on historical trends. Rather, it emanates from the view that in many developing countries, government expenditure policies are often wasteful and budgetary deficits put excessive pressure on underdeveloped financial markets.

33. In the adjustment period considered here, i.e., post 1980, the adjustment to lower budget deficits have come primarily from expenditure cuts. Increases in revenues have been difficult to achieve especially since import cuts have led to reductions in revenue from import duties as for example in Malawi. The expenditure reductions have cut heavily into public investment (which have faced the largest percentage

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13/ See Appendix A, Figures A.1 and A.2 for detailed figures derived from Lindbeck, A. (1986): "Public Finance for Market Oriented Developing Countries", Mimeo, World Bank.

reductions) and the non-interest component of current expenditure.[14] These have affected social and economic services and subsidies, and have major implications for future growth[15] and equity requiring careful consideration of alternative policies. The reduction in expenditure has not always been rational and efficient because of a variety of social and political pressures on the government.

34. When a choice is available between expenditure reduction or a revenue increase some important macroeconomic implications need to be kept in mind. One example of the differential impact of revenue increases versus expenditure reductions is the possibility that an increase in revenues would lead to a reduction in the aggregate savings rate of the economy. This is known as the Please effect and arises from the proposition that the public sector's propensity to save is lower than that of the private sector.[16] Of course the opposite is also possible. Many Asian economies have raised taxation to finance public investment and thereby raise savings and investment rates in the

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14/ Detailed figures are provided in Section III.

15/ In the SAL countries considered, negative GDP per capita growth was observed in Jamaica, Malawi, Mexico, Cote d'Ivoire, Chile, Philippines and Zambia, between 1980-86. Only Pakistan, Turkey, Thailand, Korea and Morocco (marginally) showed positive GDP per capita growth.

16/ Please, S., "Savings Through Taxation: Reality or Mirage, Finance and Development, 1967. For an empirical verification of the Please Effect see Chhibber, A. (1985): "Taxation and Aggregate Savings: An Econometric Analysis for Three Sub-Saharan African Countries", CPD Discussion Paper 1985-35, Washington, DC, World Bank.

economy. However, a recent study shows a negative[17] correlation between GDP growth and the share of public consumption in GDP. The choices made in cutting expenditures or raising resources also have wide-ranging effects on trade balances and the distribution of income. Who benefits and who loses from government expenditure and the manner in which it is financed is a key factor in the ability or inability of the government to undertake reforms.

35. Sustainable Fiscal Deficits. A related issue of more immediate concern is how much should the budget deficit be cut, or put differently, what is the sustainable level of the fiscal deficit? While in general there are close links between the size of the fiscal deficit and the external account, the nature of fiscal conditionality needs to be carefully assessed as regards its impact on internal adjustment. How the private sector adjusts to changes in fiscal policy influences its impact on external balances. If a reduction in the fiscal deficit leads to lower private savings, its effectiveness in terms of lowering the current account is reduced. Conversely, a country can run higher budget deficits without affecting the current account adversely, if the private sector is willing to generate additional net savings surpluses at reasonable rates of inflation and real interest rates, as is the case in Thailand and Malaysia. Moreover, whether the improvement in the current account is brought above by a reduction in investment or an increase in savings is fundamental to the medium-term success of the adjustment program. This is where potential conflicts arise between stabilization

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17/ B. Balassa (1988): "Public Finance and Economic Development" PPR Working Paper WPS31, July 1988.

and adjustment. There is little merit in having a close correlation between the budget deficit and the external account if the outcome is a low level of savings and investment in the economy. Thus, the quality of fiscal adjustment is as important as the quantity. The government's tax and credit policy, and the composition of public expenditures are key factors determining the outcome and are addressed in more detail in Sections III & IV.

36. The 'sustainable' level of the fiscal deficit therefore depends on a number of factors such as the cost and availability of external and internal finance, the quality and composition of the public resource mobilization and use, accompanying adjustment measures and the behavioral responses of the rest of the economy. Turkey provides an interesting example of the need to make a careful assessment of these factors in judging the sustainability of fiscal policy. Turkey repeatedly exceeded Fund fiscal targets. Undoubtedly, the financing needs commensurate with larger public sector deficits generated higher medium term inflation and real interest rates. But the thrust of the program was growth-oriented centering around export performance and the ability to keep savings and investment rates up. Fiscal policy played a key role in the process through an increase in a well-directed public expenditure program (and recommended by the Bank) which supported the private sector through special incentives and credit for export and investment and a substantial reduction in the losses of state enterprises. A key contributing factor was the substantial excess capacity inherited from the heavy investments made in the 1970s which allowed for a quick improvement in output and exports once the exchange

rate was aligned. A recent study[18] argues that the cost of a more conservative fiscal policy on growth may have been high, in the early stages of the adjustment program.

37. Turkey's fiscal deficits were sustainable upto a point because their impact was growth-oriented. In the last two years additional increases in public investment and rising interest payments on past borrowing have led to very high fiscal deficits and threaten macro-stability, requiring corrective action. The important point to keep in mind is that as shown in a previous section, while macroeconomic stability is central to successful adjustment, in a period of sharply reduced external resources, a country may need to live with a degree of mild inflation and high interest rates in order to raise savings and growth. This is especially true when the economy is saddled with excess capacity and is coming out of a recession. Designing an appropriate growth-oriented fiscal policy will require more careful country-specific quantitative analysis of the issues raised here. Because, of the much wider range of objectives it considers, the Bank will need to take on a much more active role in the design of macro-fiscal conditionality.

18/ See R. Anand, A. Chhibber and S. van Wijnbergen (1988): "External Balance, Fiscal Policy and Growth in Turkey", PPR Working Paper No. WPS86, August 1988.

III. Public Sector Resource Allocation and Use

38. The previous section showed that stabilization and adjustment programs typically require considerable changes in government expenditure policy aimed at both reducing unsustainable fiscal deficits and enhancing the growth and distributional impact of public spending. In principle, revenue-increasing measures can be used to reduce the fiscal deficit. However, given the difficulties of increasing tax revenues in the short run and possible concerns about the over-expansion of the public sector and "crowding out" of private activity, expenditure reductions are often heavily relied upon to redress fiscal deficits. With reduced or tightly controlled real public spending, there is greater need to ensure that scarce public funds are allocated to highest priority areas and used more efficiently.

39. Adjustment programs and the Bank's lending in support of them devote considerable attention to public expenditure issues. Four broad areas are generally addressed: (i) the level and composition of recurrent expenditures; (ii) the size and allocation of public investment; (iii) institutional processes and mechanisms for budgetting; and (iv) the fiscal consequences of public enterprise operations. Each of these areas are discussed in brief in the remainder of this section.

Recurrent Expenditures

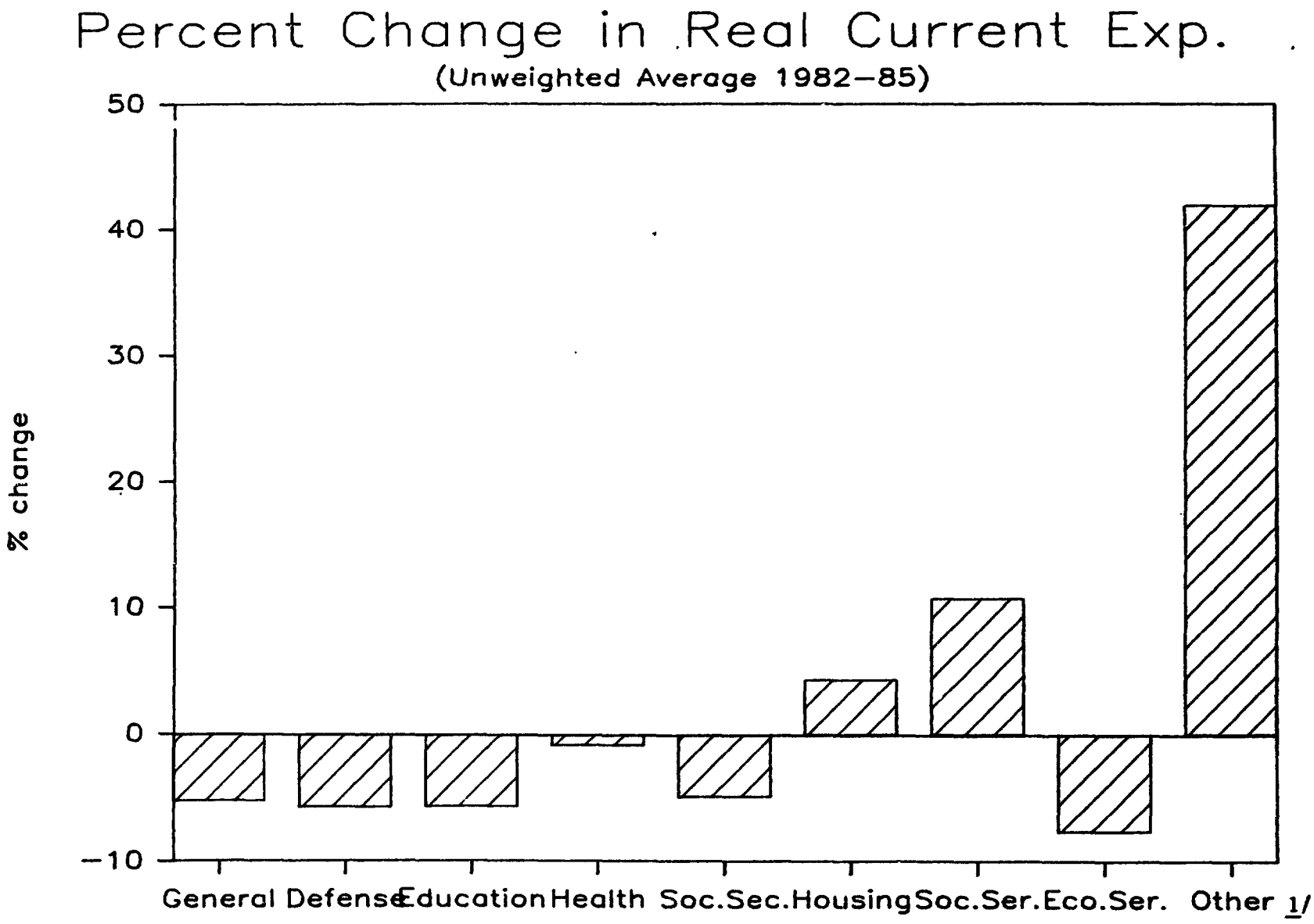
40. As noted earlier, budget deficit reduction is a major focus of the Fund standby and EFF lending. Inasmuch as Bank SALs have typically been extended concurrently with a Fund Program, the Bank has generally

been guided by Fund conditionality with respect to the fiscal deficit target and the associated revenues and expenditure indicators.[19] Only occassionally do SALs contain specific targets for overall recurrent expenditures (e.g., SAL I for Ghana or SAL II for the Philippines). More often, however, subceilings or targets for particular components of the current budget are specified. These generally relate to subsidies and spending on social sectors.

41. Figure 5 shows the changes in real expenditures across functional sectoral categories for 34 developing countries (unweighted average) during 1982-85. It indicates cuts in every category of expenditure with the exception of housing and other social services. Increasingly, there is concern that budgetary allocations for operations and maintenance are inadequate. Based on its detailed sectoral knowledge, the Bank at times has set specific targets for increases in O&M expenditures in the belief that the payoff to such outlays would be high. In some cases, SALs have stipulated a target for increased real spending on social sectors even when there has been a condition requiring a reduction in the overall deficit and/or recurrent expenditures.

19/ With the advent of the Structural Adjustment Facility and Policy Framework Papers, there is, however, greater interaction among the Bank and Fund staff in devising and agreeing upon program targets.

Figure 5



1/ Includes interest payments.

42. Among the recurrent expenditure categories most often subject to scrutiny in adjustment programs are subsidies because of the large amounts that are involved. Both explicit and implicit subsidies are covered and involve a wide range of items, including foodstuffs. The relevance, effectiveness and costs of the subsidies are examined.[20] For most products, eventual elimination of the subsidies involved should be a policy goal. Where appropriate, subsidies and cost recovery ought to be handled jointly. For some items, particularly foodstuffs, however, it may be justified to focus on better targetting of the beneficiaries both to improve the distributional impact and reduce/restrain the budgetary outlays. The Bank's adjustment lending often contains conditionality on the reduction in, and rationalization of, subsidies.

43. Analysis of recurrent expenditures other than those mentioned earlier has received much less attention in adjustment programs. The general focus of the analysis is on the impact of recurrent spending on resource use, i.e., on public savings and investment, the underlying notion being that physical investment has higher priority. The fact that returns to some recurrent expenditure can be higher than returns to investment and that expenditures which contribute to human capital are as important is being increasingly recognized.

20/ See World Bank, Bank Treatment of Subsidies, January 15, 1987.

Public Investment

44. A key aspect of fiscal adjustment in many developing countries relates to the level, composition and institutional processes of public investment. Resource constraints often dictate a relatively sharp cutback in the magnitude of public investment (see Figure 6 and Table 7), which generally has a significant balance of payments impact inasmuch as the import content of such spending exceeds that of current expenditures. Within a reduced public investment program, priority is given to projects with shorter gestation, higher rates of return. Many developing countries have, however, lacked a systematic process for evaluating public projects and for establishing multi-year budgetting requirements.

45. In recent years, the Bank has carried out numerous public investment (or, sometimes more broadly, public expenditure) reviews. A major objective of these studies has been to strengthen the Bank's ability to advise governments on the adjustments needed in their investment programs and how to improve the processes for planning, evaluating and monitoring public projects. It is, therefore, not surprising that adjustment lending, both SALs and SECALs, has embodied numerous conditions, many of a qualitative nature, on public investment.[21]

46. In the early phases of the adjustment process, the emphasis is generally on scaling down the size of the public investment program and shifting the focus away from the manufacturing sector to infrastructure

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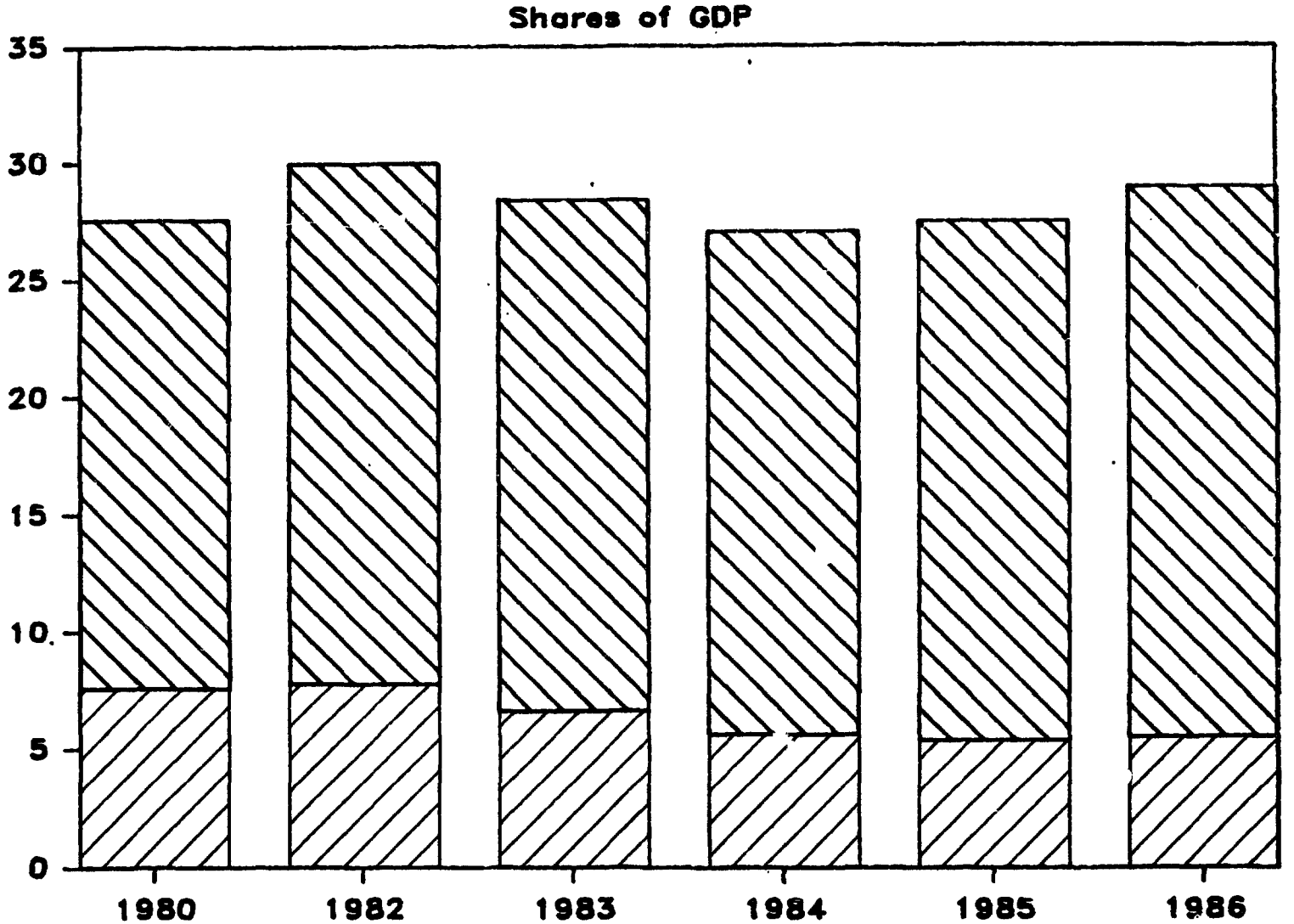
21/ Some 22 Public Investment/Expenditure Reviews were carried out during FY84-86, nearly all serving as inputs into adjustment loans.

Capital and Current Expenditure[1/]



1/ 13 SAL countries.

Table 7

Composition of Government Expenditures
(As % of Total Government Expenditure)

Country	Wages and Salaries	Interest Payments	Capital Expenditure	Subsidies and other current transfers	Other Expenditure
Argentina					
1977	.	7.6	40.0	20.0	32.2
1980	.	6.0	20.5	32.5	41.0
1984	.	8.4	17.6	34.8	39.3
Brazil					
1978	24.3	8.3	14.9	42.6	9.9
1980	23.0	8.2	12.8	45.9	10.2
1985	17.9	36.3	7.6	29.5	8.7
Chile					
1977	35.0	9.6	8.2	36.1	11.2
1980	32.2	2.9	5.4	47.4	12.1
1986	20.3	5.4	11.7	50.5	12.1
Indonesia					
1977	25.7	3.3	48.1	5.8	17.1
1980	19.6	3.7	50.2	14.9	11.7
1986	20.3	10.0	49.6	10.6	9.6
Korea a/					
1977	17.0	4.7	15.8	31.7	30.9
1980	16.0	6.6	14.1	34.2	29.1
1987	13.1	7.9	14.2	37.9	26.8
Mexico					
1977	.	9.2	22.7	23.4	44.8
1980	.	8.0	35.4	21.3	35.2
1984	.	28.9	23.2	19.9	28.0
Morocco a/					
1977	26.1	3.8	49.4	10.2	10.6
1980	33.1	7.2	31.2	14.7	13.8
1985	33.2	15.9	19.3	15.2	16.5
Pakistan a/					
1977	.	11.1	21.4	15.6	52.0
1980	.	11.9	17.4	23.3	47.4
1985	.	17.0	11.9	15.3	55.9
Thailand a/					
1977	22.9	6.5	26.5	15.3	28.7
1980	21.3	7.8	23.2	14.3	33.4
1985	29.0	14.2	19.2	7.8	29.9
Uruguay					
1977	34.5	1.4	24.5	37.8	1.9
1980	30.2	1.6	17.3	43.0	7.9
1984	26.6	8.4	16.7	40.8	7.4

a/ Countries with data on central government only.

Source: World Bank Data.

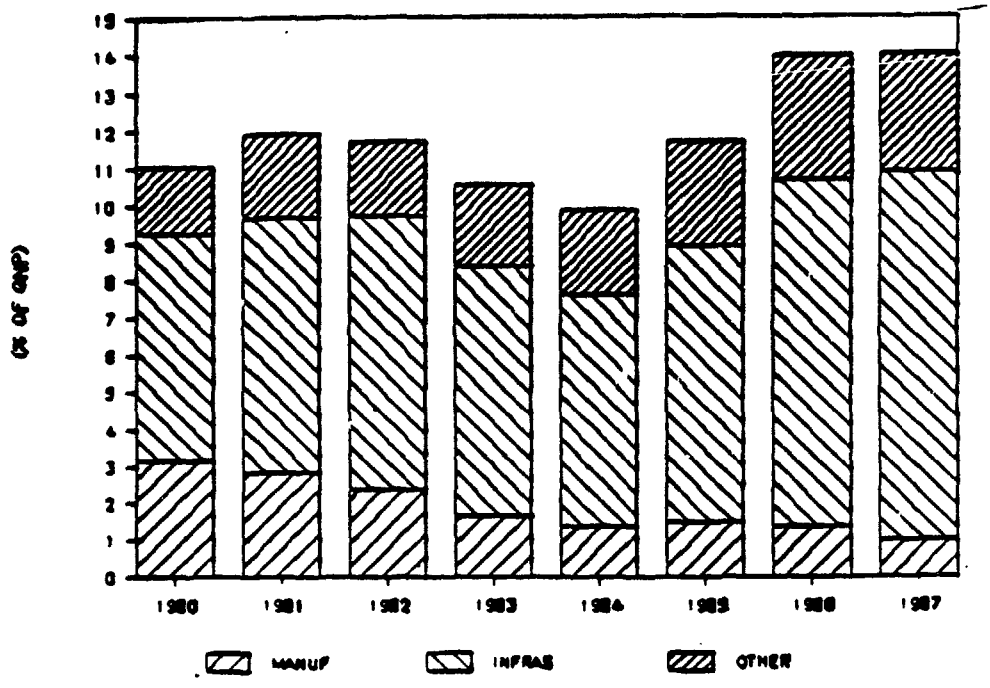
and social sectors. A "core" investment program consisting of a smaller number of projects which can be completed speedily is often devised. Pakistan and Turkey are two countries where the Bank has been successful in persuading the government to increase the emphasis towards infrastructure (see Figure 7), which has important complementary linkages with private sector productivity. Some SALs contain highly specific quantitative conditions on public investment. For example, SAL IV for Turkey required that (a) the public investment/savings gap be limited to 4.1% of GNP in 1983, (b) the 1983 growth of public investment be constrained to 5.2% in real terms as an upper limit, and (c) number of projects in the program be reduced to 6,600 with 85% of funds focused on 112 of 187 large projects. Generally, however, no explicit quantitative target for public investment is put forward in SALs. Rather, conditionality takes the form of review and agreement on the program at a specified time. It is in the course of the review process that agreement is reached on the appropriate size and composition of the program.

47. As the process of adjustment and expenditure compression has continued, there has been, however, concern about the insufficiency of public investment, particularly for infrastructural and social sectors. Thus, some recent adjustment loans have specified conditionality in terms of an increase in, or a minimum level of, public investment. SAL I for Chile and the Reconstruction Import Credit II for Ghana are examples. A reduction in the share of public investment allocated to the manufacturing sector so as to free up resources for other sectors has been another feature of SAL conditionality.

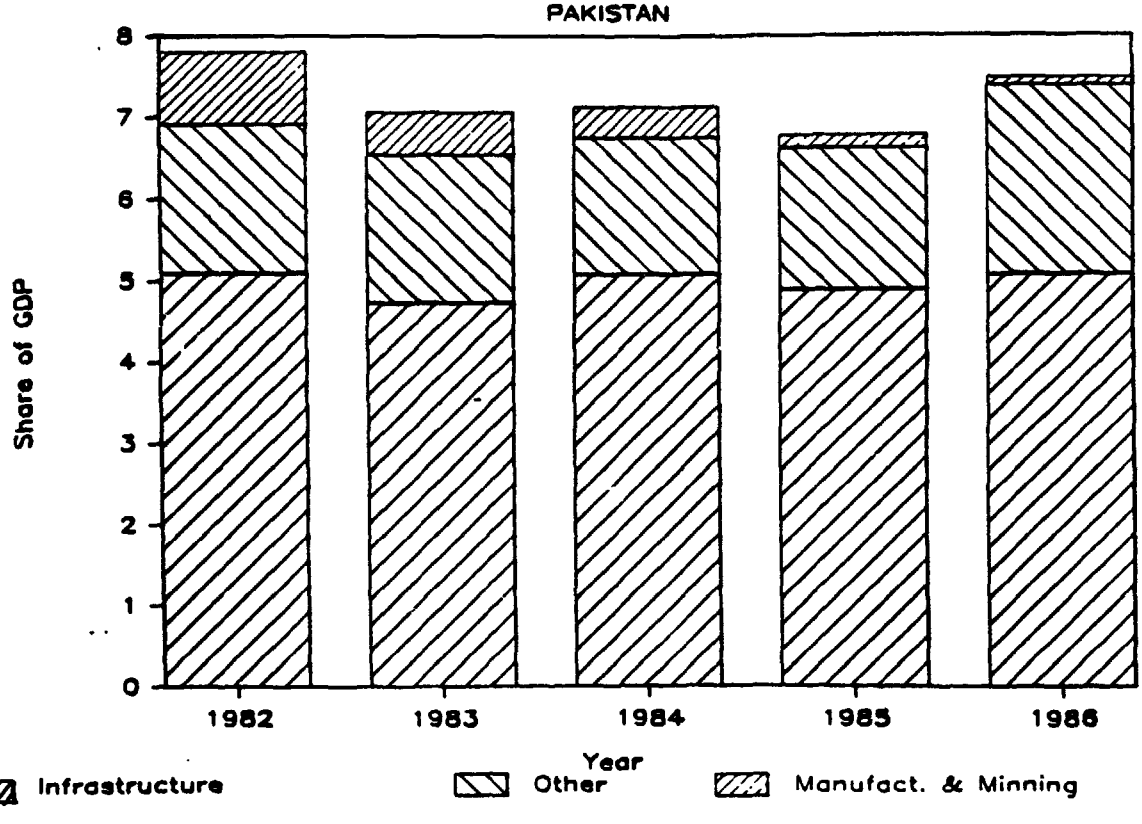
Figure 7

SECTORAL PUBLIC INVESTMENT
(as share of GNP)

TURKEY



PAKISTAN



Institutional Processes for Expenditure Policy

48. Budgetary reforms in general and improvements in the investment planning and priority-setting process as well as in capital budgetting and control in particular are widely emphasized in adjustment programs and loans. For example, the Ghana SAL I required that the IMF technical assistance recommendations on budgetting and expenditure control be implemented. It also stipulated further measures for strengthening institutional capacity for budgetting. SAL III for Côte d'Ivoire contained provisions for a program to strengthen capacity for project identification, economic evaluation and supervision in technical ministries as well as the use of "agreed criteria" for appraisal of economic and social projects. This focus on the institutional issues in the budget area arises from the belief that expenditure reforms are unlikely to be durable unless the related institutional capacity is strengthened. This type of change is often a difficult one to effect given the shortage of skilled personnel and government pay scales in most developing countries, and would, therefore, have to have an appropriately long time horizon for implementation.

Fiscal Consequences of Public Enterprise Operations[22]

49. In many developing countries, the financial performance of public enterprises has a major bearing on the government budget and the

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22/ This discussion is limited to fiscal issues only. A separate background paper treats the issues related to public enterprise reform in more depth.

allocation of resources between the public and private sectors. Budgetary transfers to finance the investment outlays of public enterprises or their operating losses often constitute a major drain on public finances. Moreover, public enterprise demands on resources are widely believed to "crowd out" private investment. There is a general presumption that successful fiscal adjustment and enhanced overall economic performance often requires not only improved efficiency of public enterprises but also a reduction in the size of the public enterprise sector. These considerations are incorporated in the design of the adjustment programs supported by the Bank.

50. Public enterprise conditionality generally covers a broad range of issues, including investment size and its financing, budgetary transfers, pricing, personnel, and divestiture. Sometimes the targets relate to the state enterprises as a whole, while in other cases, the conditions may pertain to one or a few major enterprises. Explicit quantitative conditions are particularly common with respect to the investment level for public enterprises and the contribution of the general budget to its financing (e.g., SAL II for the Philippines; various SALs for Turkey).

51. Price and rate increases constitute a major area of public enterprise conditionality. The intent is to phase out subsidies, particularly common for petroleum products, electricity and fertilizers. Border pricing for petroleum products and other homogeneous tradeables is generally the rule followed. Considerable progress has been made in

raising domestic petroleum prices to international levels. However, it has proved to be more difficult to phase out fertilizer subsidies (Pakistan, Turkey).

52. The financial performance of public enterprises, often measured as a rate of return target or a given level of self-financing, is a common focus of conditionality. What seems to receive less emphasis is the possibility that price/rate increases by public enterprises enjcying market power may even be counterproductive to efficiency improvements. This issue particularly arises in the context of electric utilities and other natural monopolies. Efforts to improve resource utilization by the utility companies have proved elusive (e.g., Bangladesh, Colombia and Indonesia where power "loss" rates remain very high).

IV. Reform of Taxation

53. Many developing countries have tax systems which generate distortions in incentives through their influence on relative prices (of both commodities and factors of production). Moreover, tax revenues are often not sufficiently buoyant with respect to growth of output and incomes and may not adequately serve equity objectives. Typically, a large proportion of tax revenues is raised through taxes on international trade, particularly imports, and excises. For example, in 1985 in low-income countries, 38 percent of tax revenues originated from taxes on international trade, with another 13 percent derived from excises (Table 8).

Table 8

Composition of Tax Revenues for Countries Grouped by Income, 1975 and 1983 a/

Tax Category b/	Low-income c/ 1975	Low-income c/ 1985	Middle-Income d/ 1975	Middle-Income d/ 1985	Industrial e/ 1975	Industrial e/ 1985
Domestic income	28	26	30	32	35	35
Individual	9	9	8	10	27	27
Corporate	18	15	17	17	7	7
Other direct taxes	5	4	18	18	33	34
Social security	1	1	12	11	29	31
Property	2	1	3	2	2	2
Domestic commodity	28	32	27	31	29	29
Sales, VAT, turnover	13	17	9	13	16	17
Excises	13	13	12	12	10	10
International trade	39	38	25	19	4	2
Import	25	28	20	17	4	2
Export	11	8	4	1	0	0

a/ Figures are unweighted representing the average pattern for countries in the sample.
b/ Figures for subcategories do not add up to the figure for each category due to the presence of smaller unallocated taxes.
c/ Low-income sample includes 11 countries.
d/ Middle-income sample includes 36 countries.
e/ Industrial market includes 19 countries.

Source: World Development Report: 1988.

54. Changes in tax systems which reduce distortions in production and improve investment/savings incentives can go a long way in effecting structural adjustment and contributing to economic growth. Moreover, by broadening the tax base, simplification, and strengthening tax administration, revenue elasticity and equity aspects of the tax system could be enhanced. Thus, adjustment programs increasingly include elements of tax reform. In designing a tax reform package, there are inevitably tradeoffs among various objectives -- revenue generation, efficiency, equity, and administrative simplicity. Administrative constraints often pose significant limitations on the overall design and

the pace of reform implementation. Nevertheless, theoretical insights and experience provide broad guidelines for reforming tax systems. The contours of desirable change include the following:

- Shifting away from taxation of production to taxing consumption in the form of a value added tax, coupled with a few excises on luxury items so as to achieve greater equity.

- Broadening of personal income taxation to include income from all sources with a top marginal rate significantly below those found in many industrial and developing countries; very few exemptions and rates.

- Simplifying and rationalizing of corporate taxation so as to have a relatively low marginal effective rate and neutrality with respect to the choice of sectors, assets and the financing composition of investment; very few rates; elimination of double taxation of dividends.

- Inflation accounting for both personal and corporate taxes.

- A reduction and simplification of tariffs based on ad-valorem rates and which serve protective rather than revenue purposes; replacement of high tariffs on luxury goods by excise taxes.

- A major strengthening of tax administration system.

55. While few countries have carried out successful comprehensive tax reforms, it is important that partial reforms be based on a sound overall design of the tax system. In particular, the reforms of international trade taxes need to be closely coordinated with that of domestic trade taxes.

Experience with Tax Reform in Adjustment Programs

56. Faced with large and unsustainable fiscal deficits, fundamental tax reform in many developing countries has been tempered by short-run revenue considerations. Indeed, given the urgency of fiscal deficit reduction, near-term revenue-enhancement measures have often tended to dominate tax policy initiatives in recent years. This has often involved an increase in excise and international trade taxes, because of the ease with which such taxes can be administered. In Malawi, for example, import duties and excises on selective goods were increased in the early 1980s. Other countries with similar experiences have included Argentina, Bangladesh, Philippines, and Thailand and more recently, Morocco, where a special surtax on imports is being increased. These ad hoc changes, however, have adverse incentive implications through increased protection and cascading effects, and tend to further complicate the tax structure.

57. The trend in tax revenues for a selected group of countries is shown in Table 9. With few exceptions, there has not been a significant increase in the tax/GDP ratio, further underscoring the earlier observation that expenditures have borne the main brunt of fiscal deficit reduction. Maintaining the tax/GDP ratio has often been achieved by the introduction of

Table 9

Government Revenues by Broad Categories
(Percentage of GDP)

Country	Domestic Direct Taxes	Domestic Indirect Taxes	Int'l Trade Taxes	Total Tax	Non Tax	Total Revenue
Chile						
1982	9.0	12.3	1.4	22.7	9.0	31.7
1986	6.3	14.1	3.0	23.4	5.6	28.9
Colombia						
1982	2.6	2.8	1.8	7.4	0.9	8.3
1986	3.3	3.5	2.2	9.6	0.5	10.1
Côte d'Ivoire						
1982	4.1	5.6	10.1	21.3	6.4	27.7
1986	3.7	5.7	9.6	20.3	11.4	31.7
Jamaica						
1982	11.9	8.9	3.0	23.9	0.9	24.8
1986	11.9	11.1	5.2	28.4	1.0	29.4
Kenya						
1982	6.5	8.2	5.0	19.7	3.4	23.1
1986	6.8	9.9	4.4	21.4	3.2	24.6
Malawi						
1982	6.4	5.9	4.2	16.7	2.9	19.6
1986	7.1	6.4	3.5	17.1	4.5	21.6
Mexico						
1983	10.6	5.6	0.5	16.8	1.0	17.8
1986	8.0	6.1	0.9	15.0	1.0	16.0
Morocco						
1982	4.6	8.7	6.4	20.1	2.6	22.7
1986	5.0	8.1	4.2	17.9	3.8	21.7
Pakistan						
1982	2.9	4.9	5.9	13.6	2.9	16.5
1986	2.2	5.8	5.8	13.8	3.7	17.5
Thailand						
1983	3.6	6.7	3.7	14.6	1.5	16.1
1986	3.4	7.9	3.5	15.6	1.5	17.1

Source: World Bank and IMF Data.

ad hoc measures, as noted above. Inelasticity of tax systems in many developing countries gives rise to the need for frequent, ad hoc changes in the taxes rates and/or base to ensure that tax revenues increase in line with GDP.

58. As part of trade liberalization programs, reform of international trade taxes has been the most common feature of tax changes aimed at improving resource allocation. Generally, the focus has been on converting specific duties to ad-valorem rates and reducing the level and variation in tariff rates. Converting QRs to tariffs has typically been an accompanying measure. Virtually all SALs and trade/industry sector adjustment loans have contained considerable conditionality with respect to tariff regimes and, by and large, significant progress has been made on this front. However, in some cases (e.g., Kenya in 1983), trade liberalization has suffered setbacks in part because of the negative revenue consequences of reduced tariffs at a time when imports were declining because of a foreign exchange shortage. In the case of Kenya, while tariff reductions and rationalization were initiated, compensatory revenue measures were not instituted. In other cases (e.g., Philippines and Thailand), tariff reform was not undertaken because of negative revenue consequences. Removal of export taxes on agricultures is at times impeded by revenue consequences, particularly as the imposition of a land tax as a substitute encounters powerful political opposition (e.g., Argentina).

59. Reform of domestic indirect taxes has been less extensive than in the case of tariffs. Several countries, including Indonesia, Korea and Turkey, have in recent years introduced a VAT as the main instrument for rationalizing their system of indirect taxation. By now, more than thirty developing countries have some form of VAT. Some VATs apply to the

manufacturing/import stage (e.g., Indonesia) while others extend to wholesale/retail stage (e.g., Korea, Turkey). The experience with VAT has been favorable, even in terms of short run revenue response. While the Fund has long advocated the introduction of a VAT as the most desirable broad-based, efficient form of commodity taxation, the Bank has generally accorded very limited attention to commodity taxation issues, except tariffs, in its economic work and adjustment lending. An important exception has been the case of Turkey where the introduction of VAT was explicitly supported in the SALs to that country as early as in 1981. Beginning in the mid-1980s, the Bank has taken a more active role in advocating VATs (e.g., the Malawi Tax Study of 1985; Bangladesh: Adjustment in the 80s and Short-term Prospects, 1988; Tunisia SAL I).

60. Progress in reforming personal and corporate income taxation has been very limited. Two broad problem areas exist in most income tax systems of developing countries. First is the presence of numerous exemptions and/or incentives which are often intended to stimulate investment/savings or serve other policy objectives. Such provisions reduce the tax base and revenues to an extent often unknown and, in the case of investment incentives which are pervasive in some countries (e.g., Morocco, Turkey), there is very little empirical evidence that they produce socially desirable results. The second aspect of income taxation where reform is warranted, particularly in high inflation countries, relates to the absence or inadequacy of indexation of both income and assets. The impact of high inflation on revenue can also be negative through collection lags and full deductability of interest expenses. The low share of income taxes in overall tax revenues, enforcement difficulties, powerful vested interests, and a genuine desire to influence saving/investment decisions account for the inertia in streamlining income taxation.

61. There have been only a few developing countries that have attempted comprehensive tax reforms. Colombia has had two major episodes (1974 and 1986). More recently, Indonesia and Mexico have had major overhauls of their tax systems. Indonesia's reform was particularly noteworthy in that it was not motivated by a fiscal crisis but was induced largely by the government's effort to reduce the dependence of its revenue base on oil income and increase the low share (about 8 percent) of non-oil taxes to GNP over the medium to longer term. The reform, introduced in 1983-84, completely overhauled income and domestic trade taxation. Not only does the new system have a broader base and is more neutral and simpler to administer, it has also produced significant revenue gains, which in turn have helped to keep the fiscal deficit within manageable limits following the sharp decline in oil prices in 1986. Indonesia's tax reform was very much undertaken on its own initiative and did not form any part of explicit or implicit conditionality in its dealing with the Bank (or the Fund).

V. Growth-Oriented Fiscal Programs: Lessons of Experience

62. Fiscal adjustment and reform are by nature difficult to design and implement given the complexity of the underlying economic and institutional factors as well as social and political sensitivities. The discussion in the previous section points to several broad conclusions as to the nature and extent of fiscal adjustment in the developing countries in this decade:

Fiscal policy reforms have often been triggered by actual or impending budgetary and balance of payment crises. Under such circumstances, short run considerations have dominated the policy measures introduced.

For a number of countries, considerable adjustment has occurred with respect to reducing the fiscal deficit and the external deficit, although several countries experienced a reversal on the budget side after 1985. As expected, the short run impact of budgetary retrenchment has generally been recessionary with a fall in investment and growth.

Reduction of the fiscal deficit has been achieved primarily through expenditure cutbacks, particularly in public investment.

Expenditure cutbacks relative to GDP have been accompanied by a more focussed public investment programs, often in the form of a "core" set of projects and activities in high priority, areas such as infrastructure. Improved allocation of recurrent expenditures has also been achieved although the reduction and elimination of some subsidies (e.g., fertilizers) has proven to be more difficult.

With a few exceptions, revenue enhancement has not been very significant because the tax systems often lack a sufficient degree of elasticity and the reduction of imports due to foreign exchange constraints has resulted in losses of tariff revenues--a main

component of tax receipts. Indeed, many countries have introduced ad hoc tax measures of an undesirable nature (on efficiency and incentive grounds) to maintain or modestly increase their tax/GDP ratios.

- Fundamental tax reform, except for tariffs, has not been a significant aspect of fiscal adjustment.

63. Growth-oriented adjustment programs entail an approach to fiscal reform which goes considerably beyond the purview of the traditional stabilization approach which emphasizes measures aimed at reducing the aggregate demand. By definition, fiscal policy changes aimed at augmenting aggregate supply take longer to bring about the desired results. Consequently, adjustment policies accenting fundamental fiscal reform require a medium term perspective. Countries suffering from severe macroeconomic imbalances need, of course, to restore a reasonable degree of stability before structural measures can be put in place and expected to elicit the desired responses. However, what constitutes a "reasonable degree" of macroeconomic correction depends on a number of factors, including the availability of external finance to support an appropriate adjustment program. Countries committed to fundamental fiscal reform--as well as other key policy areas--should be able to avail themselves of the necessary

financial support within a time frame that allows them to initiate and sustain the process of change. In this context, the tradeoff between a rigid focus on stabilization and adjustment should be recognized and considered.[23]

64. SALs remain the most appropriate vehicle for supporting fiscal reform because of their economy-wide approach. In principle, there is no reason why a series of fiscal-based SALs could not be designed for a country willing to undertake structural and institutional reforms in the areas of expenditure policy, taxation, and public sector pricing. Considerable preparation in the form of studies with a policy focus would, however, need to precede such lending operations for them to be effective. The Bank has in recent years carried out many "Public Investment (Expenditure) Reviews", some of which have served, as noted earlier, as inputs into SALs. More sharply focussed studies of this type, including those on the revenue side, would need to be undertaken to underpin carefully the adjustment programs and lending. SAL conditionality would need to be geared towards reform actions as opposed to necessarily short-run improvements in key macro targets (e.g., the budget deficit). In countries where there is an acute stabilization problem, aggregate demand reduction measures would also need to be included. In any event, multi-year financing commitment would be required to help persuade governments to undertake the reforms and to sustain them.[24]

23/ The World Bank and IMF are increasingly recognizing the need for refocussing fiscal reform packages to include supply-side measures and are proposing a change in its policy in this direction as evidenced in recent internal policy documents.

24/ See S. Fischer, "Issues in Medium-Term Macroeconomic Adjustment", The World Bank Research Observer, VL.1, July 1986, for a discussion of multi-year structural adjustment programs and financing.

65. Greater Bank involvement in adjustment lending based on fiscal reform and the Fund's growing concern with growth-oriented adjustment programs imply a greater need for coordination and collaboration between the two institutions in designing mutually-reinforcing operations. In this context, there should be a clear understanding that fiscal policy issues are a matter of concern for both institutions and could be the basis for the lending operations of either entity. The increased awareness of the need for growth-oriented adjustment programs in general, and the central role of fiscal policy in their design implies that the Bank will be required to take a much more active role in this area.

BOX Targetting the Budget Deficit: Clarifying Concepts

The fiscal deficit is a very important component of the policy package in adjustment programs. In order to monitor its size, adjustment programs usually set targets on net domestic credit to the government or the private sector as well as on commercial borrowing by the government (or public sector) from abroad. To avoid the possibility of the government borrowing excessively from the non-bank public, adjustment programs often also include targets on the size of the deficit, thereby limiting the need for such borrowing. This is done in order to ensure that the private sector is not crowded-out for financial resources.

In designing adjustment programs, do the commonly used concepts of the budget deficit provide an accurate indication of the fiscal stance of the public sector viz-a-vis the rest of the economy or are they misleading? Would it be useful to complement the standard budget deficit with other measures? These issues are often decided by the availability of data. But, the discussions on these questions have improved understanding of the impact of the government on the economy; and have shown that it is important to understand the limitations of the commonly used measures.

Earlier programs often only look at the public finances of the central government. The central government's deficit or its net borrowing requirement was defined as central government expenditure net of central government revenue. This was obviously an insufficient measure as a substantial part of government activity consists of public enterprises and state of local governments. It is now common to measure the net financing requirement of the entire public sector called the consolidated public sector

deficit or the public sector borrowing requirement (PSBR). This measures the net use of financial resources by the public sector and consequently its impact on the balance of payments, inflation, credit to the private sector and domestic interest rates.

In dealing with high inflation countries the concept of the operational deficit or inflation-corrected deficit is very useful. The operational deficit is defined as the PSBR minus the inflation correction part of interest payments. This is necessary because with high inflation the real value of the government's debt has fallen, and a part of the interest payments (which should be deducted) only compensates debt-holders for inflation. A few recent programs have used this as a supplementary criterion. In countries with a large debt overhang it is useful to measure the non-interest or primary deficit. This is an indicator of the impact of fiscal policy in a particular year on the public sector's net indebtedness; and provides an assessment of trends in underlying government accounts net of the inherited debt problem.

Another concept sometimes found useful is the structural deficit. This concept is suggested in cases where temporary factors such as fluctuations in commodity prices, sale of public assets (privatization), a tax amnesty or for that manner any fluctuation in GDP from trend values leads to a temporary change in public finances without changing underlying trends in government expenditure or revenue. It can be particularly useful in avoiding a commonly observed problem in many developing countries of increasing expenditures during a commodity boom followed by large deficits when prices fall. Automatic adjustors are often specified to the overall deficit or credit ceilings to account for unexpected shortfalls or a bonanza.

A more difficult issue associated with targetting arises from distinguishing ex-ante between what will be called here the first order deficit and the subsequent increase in the deficit brought about by changes in inflation and domestic interest rates or for that matter other channels which affect the budget deficit. For example, accelerating inflation erodes revenues because of collection lags, tax evasion or lack of indexation, creating even larger deficits. This is known as the Tanzi effect. Studies show that the impact of these lags can be large in high inflation countries. A similar situation arises when the government finances its deficit through domestic borrowing. Now interest rates rise due to inflationary expectations, resulting in large interest payments, which in turn raise the deficit even further. Turkey, and Brazil provides a striking example of this type of vicious spiral in domestic interest rates, domestic interest payments and the deficit.

What does this imply for targetting budget deficits? The first-order deficit reduction required for macro-stability is smaller than the deficit shown by the PSBR. This is because a part of the deficit reduction will come automatically as the rate of interest and inflation fall with an initial reduction in first-order deficit (Note that a fall in inflation will have other consequences such as a fall in revenue from the inflation tax). The PSBR can over-estimate the reduction in the fiscal deficit required to correct macro imbalances. It can therefore lead to recommendations which require larger expenditure reduction and revenue enhancing measures than are warranted.

A final measure of the deficit that is often used in evaluating government finances is the current deficit i.e. current expenditure net of current revenues. A surplus on this account shows that the government is a net saver. A deficit shows that the government is using a part of the taxed savings of the private sector for its current expenditure needs. In general it is desirable to increase government savings (reduce current deficit). However, one must be careful. If this is brought about for example by reducing maintenance expenditures to increase investments or by reducing current outlays on public health services to build a hospital its overall impact may not be beneficial.

Table 1

Definitions of the Budget Deficit

Central Government Deficit	=	Central Government Expenditure	-	Central Government Revenue
Public Sector Borrowing Requirements (PSBR)	=	Total Public Expenditure	-	Total Public Revenue
Operation Deficit (inflation corrected deficit)	=	PSBR	-	Inflation corrected part of interest-payment
Primary Deficit (non-interest deficit)	=	PSBR	-	interest-payments
Structural Deficit	=	PSBR	-	temporary factors (commodity booms or busts, droughts sale of assets)
First-Order Deficit	=	PSBR	-	Tanzi Effect - effect of inflationary expectations on interest rates
Current Deficit	=	Current Expenditure	-	Total Revenue

Appendix A: Table A.1

Effective Reserve Requirements on Deposits in Domestic Banking System a/

		1981	1982	1983	1984	1985	1986
High							
	Argentina	0.146	0.891	0.797	0.550	0.483	0.222
	Uruguay	0.065	0.176	0.422	0.341	0.333	0.348
	Colombia	0.422	0.396	0.359	0.351	0.354	NA
	Ghana	0.473	0.438	0.454	0.630	0.501	0.636
	Malawi	0.154	0.152	0.141	0.284	0.306	0.484
	Mexico	0.467	0.609	0.632	0.566	0.413	0.302
	Turkey	0.317	0.277	0.304	0.294	0.257	0.215
	Jamaica	0.158	0.024	0.118	0.270	0.278	0.393
Moderate							
	Brazil	0.185	0.210	0.167	0.150	0.106	0.185
	Bangladesh	0.100	0.098	0.093	0.094	0.096	0.091
	Indonesia	0.205	0.248	0.163	0.161	0.159	NA
	Nigeria	0.137	0.175	0.096	0.070	0.050	0.088
	Ivory Coast	0.061	0.048	0.058	0.072	0.124	0.140
	Kenya	0.065	0.105	0.071	0.077	0.098	0.116
	Pakistan	0.101	0.091	0.089	0.121	0.105	0.100
	Philippines	0.114	0.090	0.106	0.132	0.139	0.193
	Zambia	0.177	0.146	0.162	0.195	0.211	0.284
Low							
	Tunisia	0.039	0.023	0.028	0.033	0.028	0.018
	Korea	0.054	0.069	0.056	0.040	0.040	0.043
	Morocco	0.023	0.018	0.015	0.025	0.017	0.048
	Thailand	0.048	0.041	0.039	0.030	0.040	0.037

Source: International Financial Statistics

a/ Line 20 divided by sum of Line 24 & 25.

Appendix A: Table A.2

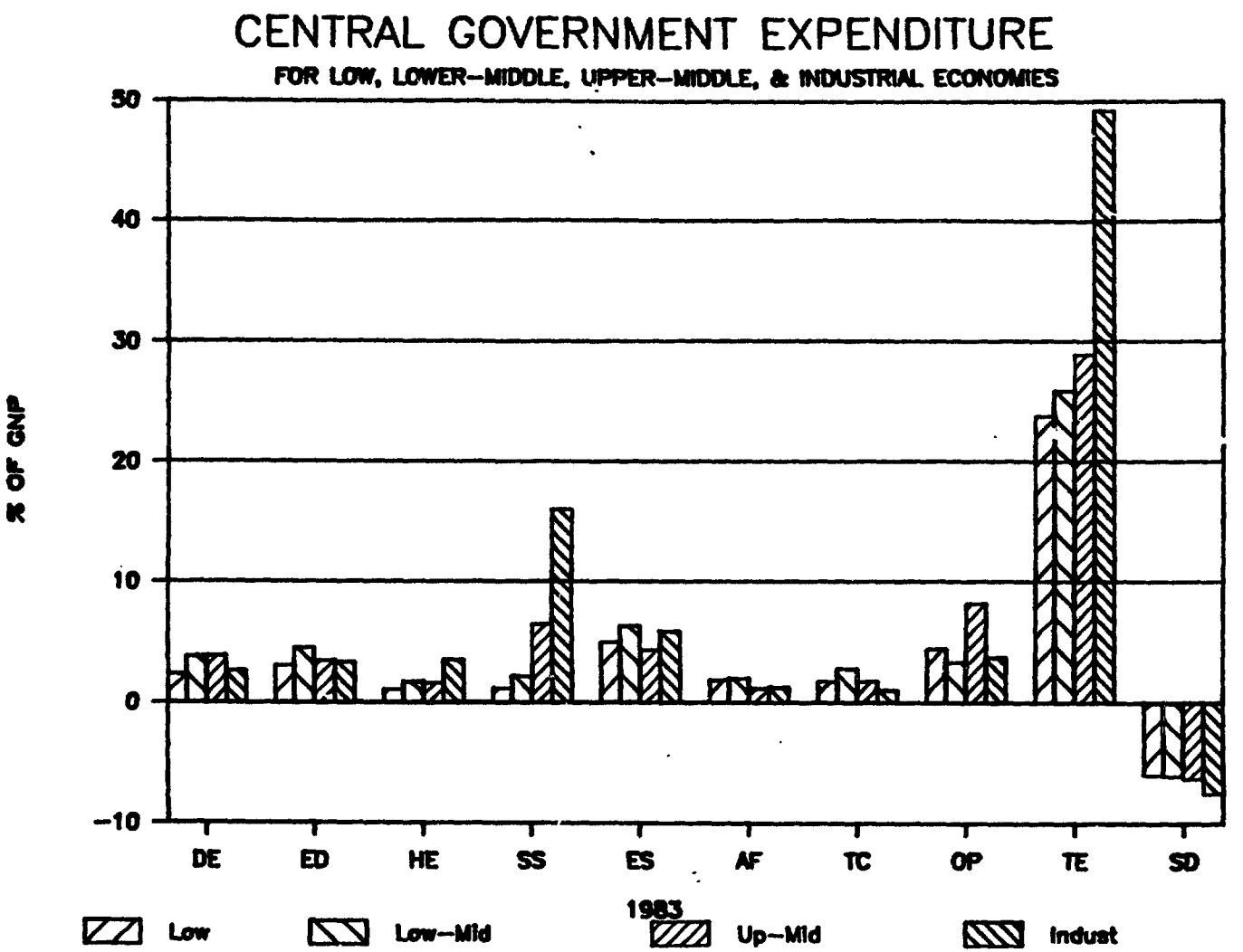
AVERAGE INTEREST RATE ON PUBLIC-SECTOR DOMESTIC DEBT
Per cent per annum

	1980	1981	1982	1983	1984	1985
I. Hyperinflation						
Argentina						
Interest rate a/	19.9	30.9	19.2	10.4	7.2	11.2
Consumer prices b/	100.8	104.5	104.5	343.8	626.7	673.4
Brazil						
Interest rates	35.4	89.0	131.3	136.7	250.2	270.4
Consumer prices	92.8	98.6	100.4	133.4	188.8	224.6
II. High Inflation						
Mexico						
Interest rate	10.8	16.9	21.7	28.5	37.3	32.6
Consumer prices	26.3	27.9	58.9	101.9	645.4	57.7
Philippines						
Interest rate	12.0	11.9	13.8	14.2	28.5	33.2
Consumer prices	18.2	13.1	10.2	10.0	50.4	21.7
III. Low Inflation						
Indonesia						
Interest rate	9.0	9.0	9.0	9.0	9.0	9.0
Consumer prices	18.5	12.2	9.5	11.8	10.4	3.7
Korea						
Interest rate	11.6	10.5	8.8	7.2	9.1	7.8
Consumer prices	28.7	21.3	7.3	3.4	2.3	1.7
Venezuela						
Interest rate	7.1	8.4	11.8	13.2	13.5	13.0
Consumer prices	21.5	16.2	9.5	6.2	12.2	10.7

a/ Derived from comparing the annual interest expense on domestic indebtedness incurred by the non-financial public sector with the estimated mid-year stock of its domestic debt.
b/ Annual increase as a percentage.

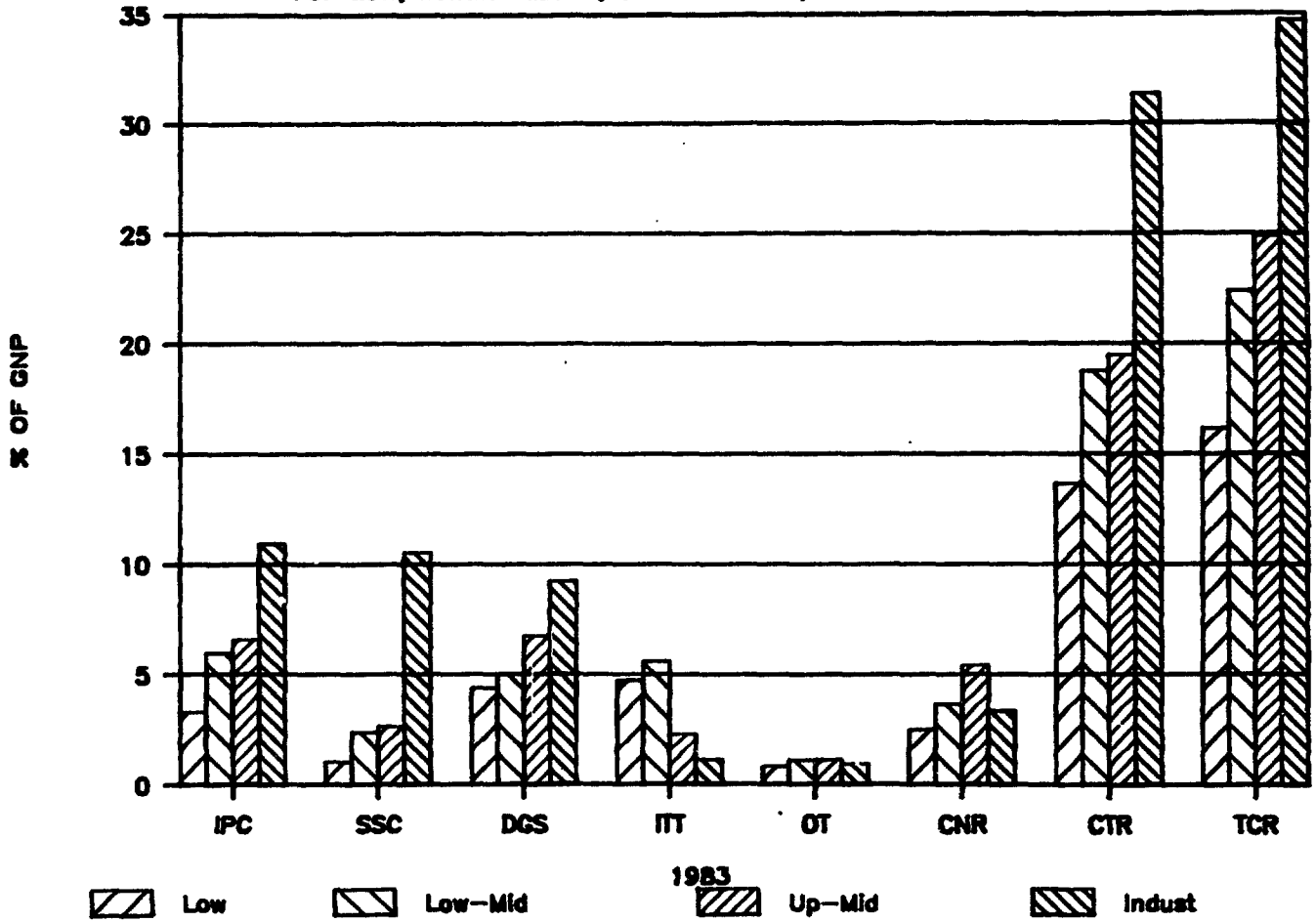
Source: Helmut Reisen and A. van Trotsenburg "Developing Country Debt: The Budgetary and Transfer Problem," OECD, Paris, 1988.

Appendix A: Figure A.1



CENTRAL GOVERNMENT CURRENT REVENUE

FOR LOW, LOWER-MIDDLE, UPPER-MIDDLE, & INDUSTRIAL ECONOMIES



IPC = Taxes on income, profit, and capital gains
SSC = Social security contributions
DCS = Domestic taxes on goods and services
ITT = Taxes on international trade and transactions
OT = Other taxes
CNR = Current nontax revenue
CTR = Current tax revenue
TCR = Total current revenue

Source: See Lindbeck, Assar (1986): "Public Finance for Market Oriented Developing Countries," Mimeo, The World Bank, Washington, D.C.

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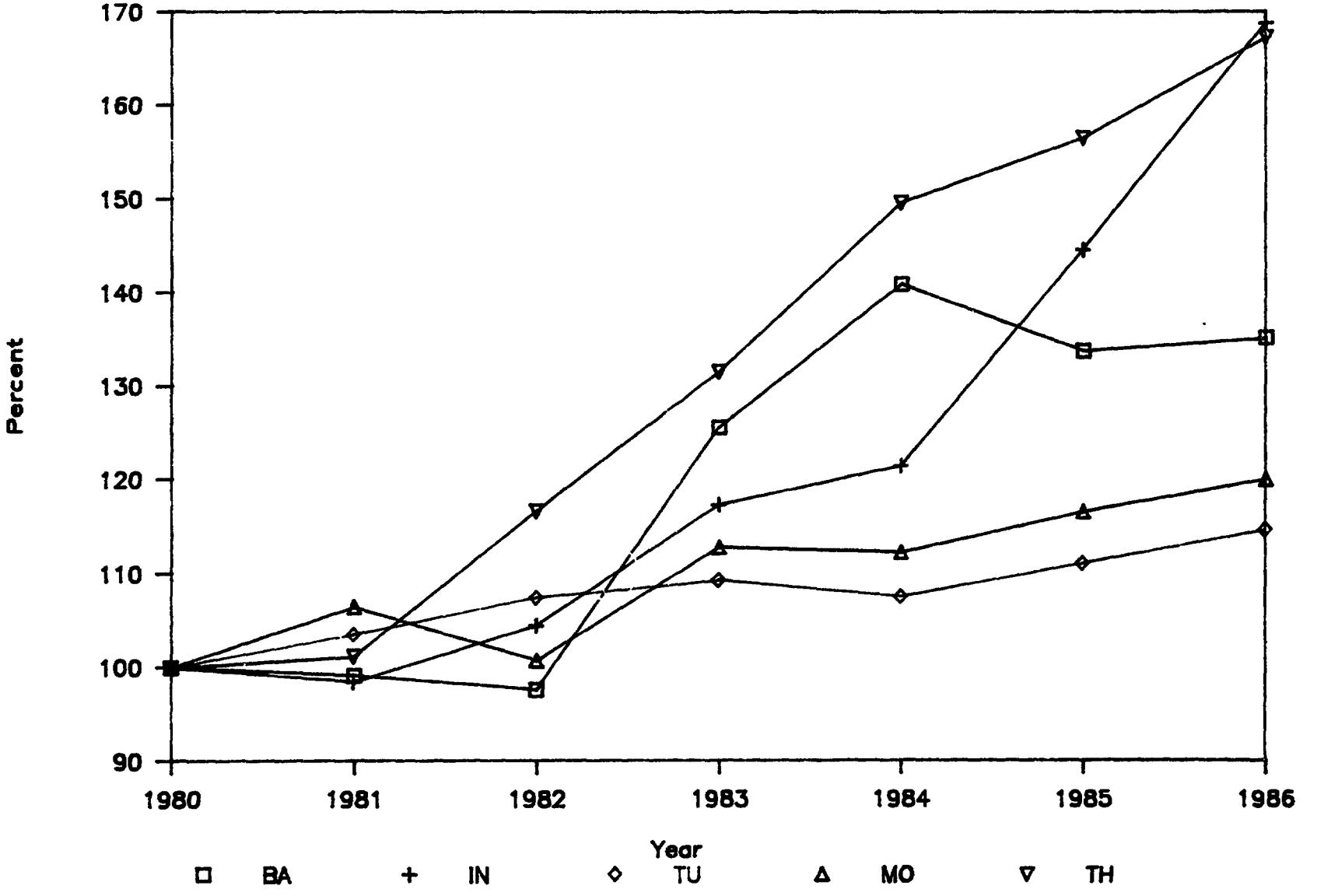
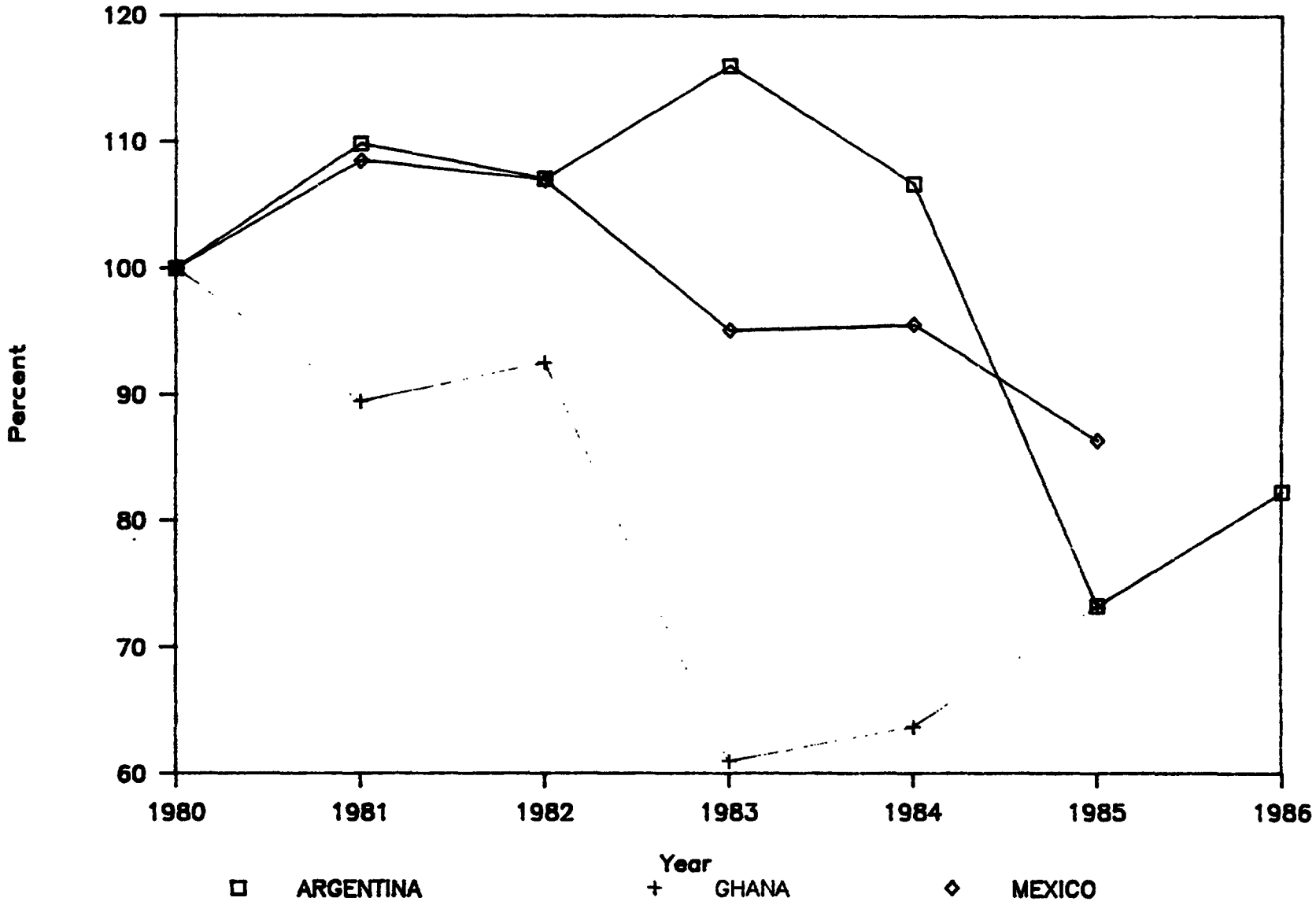
Low Inflation Countries



High Inflation Countries



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